Subject File

INTEREST EQUALIZATION TAX ACT

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-EIGHTH CONGRESS

SECOND SESSION

ON

H.R. 8000

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO IMPOSE A TAX ON ACQUISITIONS OF CERTAIN FOREIGN SECURITIES IN ORDER TO EQUALIZE COSTS OF LONGER TERM FINANCING IN THE UNITED STATES AND IN MARKETS ABROAD, AND FOR OTHER PURPOSES

JUNE 29, 30; JULY 1 AND 2, 1964

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

34-937 WASHINGTON : 1964

COMMITTEE ON FINANCE

HARRY FLOOD BYRD, Virginia, *Chairman*

RUSSELL B. LONG, Louisiana
GEORGE A. SMATHERS, Florida
CLINTON P. ANDERSON, New Mexico
PAUL H. DOUGLAS, Illinois
ALBERT GORE, Tennessee
HERMAN E. TALMADGE, Georgia
EUGENE J. McCARTHY, Minnesota
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
ABRAHAM A. RIBICOFF, Connecticut

JOHN J. WILLIAMS, Delaware
FRANK CARLSON, Kansas
WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
THRUSTON B. MORTON, Kentucky
EVERETT McKINLEY DIRKSEN, Illinois

ELIZABETH B. SPRINGER, *Chief Clerk*

CONTENTS

WITNESSES

COMMUNICATIONS

COMMUNICATIONS—Continued

EXHIBITS

INTEREST EQUALIZATION TAX ACT

MONDAY, JUNE 29, 1964

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2221, New Senate Office Building, Senator Paul H. Douglas presiding.

Present: Senators Douglas (presiding), Smathers, Gore, McCarthy, Williams, Carlson, Bennett, Morton, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

Senator DOUGLAS. The committee will come to order.

In the absence of more senior members of the committee, I have been asked to assume the temporary duty as presiding officer. I place in the record a copy of the bill H.R. 8000 and a letter dated June 12, 1964, from the Secretary of the Treasury with accompanying amendments recommended by the Treasury Department.

(The bill, letter from the Secretary of the Treasury, and amendments recommended by the Treasury Department, follow:)

[H.R. 8000, 88th Cong., 2d sess.]

AN ACT To amend the Internal Revenue Code of 1954 to impose a tax on acquisitions of certain foreign securities in order to equalize costs of longer-term financing in the United States and in markets abroad, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Interest Equalization Tax Act of 1963".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment is expressed in terms of an amendment to a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. INTEREST EQUALIZATION TAX.

(a) IMPOSITION OF TAX.—Subtitle D (relating to miscellaneous excise taxes) is amended by adding at the end thereof the following new chapter:

"CHAPTER 41—INTEREST EQUALIZATION TAX

"SEC. 4911. IMPOSITION OF TAX.

"(a) IN GENERAL.—There is hereby imposed, on each acquisition by a United States person (as defined in section 4920(a)(4)) of stock of a foreign issuer, or of a debt obligation of a foreign obligor (if such obligation has a period remaining to maturity of 3 years or more), a tax determined under subsection (b).

"(b) AMOUNT OF TAX.—

"(1) STOCK.—The tax imposed by subsection (a) on the acquisition of stock shall be equal to 15 percent of the actual value of the stock.

"(2) DEBT OBLIGATIONS.—The tax imposed by subsection (a) on the acquisition of a debt obligation shall be equal to a percentage of the actual value of the debt obligation measured by the period remaining to its maturity and determined in accordance with the following table:

"If the period remaining to maturity is:	The tax, as a percentage of actual value, is:
"At least 3 years, but less than 3½ years	2.75 percent
At least 3½ years, but less than 4½ years	3.55 percent
At least 4½ years, but less than 5½ years	4.35 percent
At least 5½ years, but less than 6½ years	5.10 percent
At least 6½ years, but less than 7½ years	5.80 percent
At least 7½ years, but less than 8½ years	6.50 percent
At least 8½ years, but less than 9½ years	7.10 percent
At least 9½ years, but less than 10½ years	7.70 percent
At least 10½ years, but less than 11½ years	8.30 percent
At least 11½ years, but less than 13½ years	9.10 percent
At least 13½ years, but less than 16½ years	10.30 percent
At least 16½ years, but less than 18½ years	11.35 percent
At least 18½ years, but less than 21½ years	12.25 percent
At least 21½ years, but less than 23½ years	13.05 percent
At least 23½ years, but less than 26½ years	13.75 percent
At least 26½ years, but less than 28½ years	14.35 percent
28½ years or more	15.00 percent

"(c) PERSONS LIABLE FOR TAX.—

"(1) IN GENERAL.—The tax imposed by subsection (a) shall be paid by the person acquiring the stock or debt obligation involved.

"(2) CROSS REFERENCE.—

"For imposition of penalty on maker of false certificate in lieu of or in addition to tax on acquisition in certain cases, see section 6681.

"(d) TERMINATION OF TAX.—The tax imposed by subsection (a) shall not apply to any acquisition made after December 31, 1965.

"SEC. 4912. ACQUISITIONS.

"(a) IN GENERAL.—For purposes of this chapter, the term 'acquisition' means any purchase, transfer, distribution, exchange, or other transaction by virtue of which ownership is obtained either directly or through a nominee, custodian, or agent. A United States person acting as a fiscal agent in connection with the redemption or purchase for retirement of stock or debt obligations (whether or not acting under a trust arrangement) shall not be considered to obtain ownership of such stock or debt obligations. The exercise of a right to convert a debt obligation (as defined in section 4920(a)(1)) into stock shall be deemed an acquisition of stock from the foreign issuer by the person exercising such right. Any extension or renewal of an existing debt obligation requiring affirmative action of the obligee shall be considered the acquisition of a new debt obligation.

"(b) SPECIAL RULES.—For purposes of this chapter.—

"(1) CERTAIN TRANSFERS TO FOREIGN TRUSTS.—Any transfer (other than in a sale or exchange for full and adequate consideration) of money or other property to a foreign trust shall, if such trust acquires stock or debt obligations (of one or more foreign issuers or obligors) the direct acquisition of which by the transferor would be subject to the tax imposed by section 4911, be deemed an acquisition by the transferor (as of the time of such transfer) of stock of a foreign issuer in an amount equal to the actual value of the money or property transferred or, if less, the actual value of the stock or debt obligations so acquired by such trust. Contributions to a

foreign pension or profit-sharing trust established by an employer, made by an employee who performs personal services for such employer on a full-time basis in a foreign country (and is not an owner-employee as defined in section 401(c)(3)), shall not be considered under the preceding sentence as transfers which may be deemed acquisitions of stock of a foreign issuer.

"(2) CERTAIN TRANSFERS TO FOREIGN CORPORATIONS AND PARTNERSHIPS.—Any transfer of money or other property to a foreign corporation or a foreign partnership—

"(A) as a contribution to the capital of such corporation or partnership, or

"(B) in exchange for one or more debt obligations of such corporation or partnership, if it is a foreign corporation or partnership which is formed or availed of by the transferor for the principal purpose of acquiring (in the manner described in section 4915(c)(1)) an interest in stock or debt obligations the direct acquisition of which by the transferor would be subject to the tax imposed by section 4911,

shall be deemed an acquisition by the transferor of stock of a foreign corporation in an amount equal to the actual value of the money or property transferred.

"(3) ACQUISITIONS FROM DOMESTIC CORPORATION OR PARTNERSHIP FORMED OR AVAILED OF TO OBTAIN FUNDS FOR FOREIGN ISSUER OR OBLIGOR.—The acquisition of stock or a debt obligation of a domestic corporation (other than a domestic corporation described in section 4920(a)(3)(B)), or a domestic partnership, formed or availed of for the principal purpose of obtaining funds (directly or indirectly) for a foreign issuer or obligor, shall be deemed an acquisition (from such foreign issuer or obligor) of stock or a debt obligation of such foreign issuer or obligor.

"(4) REORGANIZATION EXCHANGES.—Any acquisition of stock or debt obligations of a foreign issuer or obligor in an exchange to which section 354, 355, or 356 applies (or would, but for section 367, apply) shall be deemed an acquisition from the foreign issuer or obligor in exchange for its stock or for its debt obligations.

"SEC. 4913. LIMITATION ON TAX ON CERTAIN ACQUISITIONS.

"(a) CERTAIN SURRENDERS, EXTENSIONS, RENEWALS, AND EXERCISES.—

"(1) GENERAL RULE.—If stock or a debt obligation of a foreign issuer or obligor is acquired by a United States person as the result of—

"(A) the surrender to the foreign obligor, for cancellation, of a debt obligation of such obligor;

"(B) the extension or renewal of an existing debt obligation requiring affirmative action of the obligee; or

"(C) the exercise of an option or similar right to acquire such stock or debt obligation (or a right to convert a debt obligation into stock),

then the tax imposed on such acquisition shall not exceed the amount determined under paragraph (2) or (3).

"(2) GENERAL LIMITATION.—Except in cases to which paragraph (3) applies, the tax imposed upon an acquisition described in paragraph (1) shall be limited to—

"(A) the amount of tax imposed by section 4911, less

"(B) the amount of tax which would have been imposed under section 4911 if the debt obligation which was surrendered, extended, or renewed, or the option or right which was exercised, had been acquired in a transaction subject to such tax immediately before such surrender, extension, renewal, or exercise.

For purposes of this paragraph, a defaulted debt obligation of the government of a foreign country or a political subdivision thereof (or an agency or instrumentality of such a government) which has been in default as to principal for at least 10 years and which is surrendered in exchange for another debt obligation of that government (or agency or instrumentality) shall be deemed to have an actual value and period remaining to maturity equal to that of the debt obligation acquired.

"(3) SPECIAL LIMITATIONS.—

"(A) CONVERSIONS OF DEBT OBLIGATIONS INTO STOCK.—The tax imposed upon an acquisition of stock pursuant to the exercise of a right to convert a debt obligation (as defined in section 4920(a)(1)) into stock shall be limited to—

"(i) the amount of tax which would have been imposed by section 4911 if the debt obligation, pursuant to section 4920(a) (2) (D), had been treated as stock at the time of its acquisition by the person exercising the right (or by a decedent from whom such person acquired the right by bequest or inheritance or by reason of such decedent's death), less

"(ii) the amount of tax paid by the person exercising the right (or by such decedent) as a result of the acquisition of the convertible debt obligation.

"(B) EXERCISE OF CERTAIN SHAREHOLDERS' RIGHTS.—The tax imposed upon an acquisition of stock or a debt obligation of a foreign corporation by a United States person who is a shareholder of such corporation, where—

"(i) the stock or debt obligation is acquired pursuant to the exercise of an option or similar right to acquire such stock or debt obligation which was acquired by such person in a distribution by such corporation with respect to its stock, and

"(ii) such option or right by its terms expires or terminates within a period not exceeding 90 days from the date so distributed to him,

shall be limited to the amount of tax which would have been imposed by section 4911 if the price paid under such option or right were the actual value of the stock or debt obligation acquired.

"(C) CERTAIN EMPLOYEE STOCK OPTIONS.—The tax imposed upon an acquisition of stock of a foreign issuer by a United States person pursuant to the exercise of an option or similar right described in section 4914(a)(7) shall be limited to the amount of tax which would have been imposed under section 4911 if the price paid under such option or right were the actual value of the stock acquired.

"(b) CERTAIN TRANSFERS WHICH ARE DEEMED ACQUISITIONS.—The tax imposed upon an acquisition which is deemed to have been made by reason of a transfer of money or other property to a foreign trust, or a foreign corporation or partnership, as described in section 4912(b) (1) or (2), shall be limited to—

"(1) the amount of tax imposed by section 4911, less

"(2) the amount of tax paid by the transferor as the result of the transfer being otherwise taxable as an acquisition under this chapter.

"SEC. 4914. EXCLUSION FOR CERTAIN ACQUISITIONS.

"(a) TRANSACTIONS NOT CONSIDERED ACQUISITIONS.—The term 'acquisition' shall not include—

"(1) any transfer between a person and his nominee, custodian, or agent;

"(2) any transfer described in section 4343(a) (relating to certain transfers by operation of law from decedents, minors, incompetents, financial institutions, bankrupts, successors, foreign governments and aliens, trustees, and survivors);

"(3) any transfer by legacy, bequest, or inheritance to a United States person, or by gift to a United States person who is an individual;

"(4) any distribution by a corporation of its stock or debt obligations to a shareholder with respect to or in exchange for its stock;

"(5) any exchange to which section 361 applies (or would, but for section 367, apply), where the transferor corporation was a domestic corporation and was engaged in the active conduct of a trade or business, other than as a dealer in securities, immediately before the date on which the assets involved are transferred to the acquiring corporation;

"(6) any exercise of a right to convert indebtedness, pursuant to its terms, into stock, if such indebtedness is treated as stock pursuant to section 4920 (a) (2) (D); or

"(7) the grant of a stock option or similar right to a United States person who is an individual, for any reason connected with his employment by a corporation, if such option or right (A) is granted by the employer corporation, or its parent or subsidiary corporation, to purchase stock of any of such corporations, and (B) by its terms is not transferable by such United States person otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him.

"(b) EXCLUDED ACQUISITIONS.—The tax imposed by section 4911 shall not apply to the acquisition—

"(1) THE UNITED STATES.—Of stock or debt obligations by an agency or wholly owned instrumentality of the United States.

"(2) COMMERICAL BANK LOANS.—

"(A) Of debt obligations by a commercial bank in making loans in the ordinary course of its commercial banking business.

"(B) Of stock or debt obligations by a commercial bank through foreclosure, where such stock or debt obligations were held as security for loans made in the ordinary course of its commercial banking business.

"(3) ACQUISITIONS REQUIRED UNDER FOREIGN LAW.—Of stock or debt obligations by a United States person doing business in a foreign country to the extent that such acquisitions are reasonably necessary to satisfy minimum requirements relating to holdings of stock or debt obligations of foreign issuers or obligors imposed by the laws of such foreign country; except that if any of such requirements relate to the holding of insurance reserves, the exclusion otherwise allowable under this paragraph with respect to acquisitions made by such United States person during any calendar year shall be reduced by the maximum amount of the exclusion which could be allowed under subsection (e) with respect to acquisitions made by such person during that year, or by the amount of the insurance reserves which must be held in order to satisfy such requirements, whichever is less.

"(4) EXPORT CREDIT, ETC., TRANSACTIONS.—Of stock or debt obligations arising from the sale of property or services by United States persons, to the extent provided in subsection (c).

"(5) LOANS TO ASSURE RAW MATERIALS SOURCES.—Of debt obligations by United States persons in connection with loans made to foreign corporations to assure raw materials sources, to the extent provided in subsection (d).

"(6) ACQUISITIONS BY INSURANCE COMPANIES DOING BUSINESS IN FOREIGN COUNTRIES.—Of stock or debt obligations by insurance companies doing business in foreign countries, to the extent provided in subsection (e).

"(7) ACQUISITIONS BY CERTAIN TAX-EXEMPT LABOR, FRATERNAL, AND SIMILAR ORGANIZATIONS HAVING FOREIGN BRANCHES OR CHAPTERS.—Of stock or debt obligations by certain tax-exempt United States persons operating in foreign countries through local organizations, to the extent provided in subsection (f).

"(c) EXPORT CREDIT, ETC., TRANSACTIONS.—

"(1) IN GENERAL.—The tax imposed by section 4911 shall not apply to the acquisition from a foreign obligor of a debt obligation arising out of the sale of tangible personal property or services (or both) to such obligor by any United States person, if—

"(A) payment of such debt obligation is guaranteed or insured, in whole or in part, an agency or wholly owned instrumentality of the United States; or

"(B) the United States person acquiring such debt obligation makes the sale in the ordinary course of his trade or business and not less than 85 percent of the purchase price is attributable to the sale of property manufactured, produced, grown, or extracted in the United States, or to the performance of services by such United States person (or by one or more includible corporations in an affiliated group, as defined in section 1504, of which such person is a member), or to both.

The term 'services', as used in this paragraph and paragraph (2), shall not be construed to include functions performed as an underwriter.

"(2) ALTERNATE RULE FOR PRODUCING EXPORTERS.—The tax imposed by section 4911 shall not apply to the acquisition by a United States person from a foreign issuer or obligor of its stock in payment for, or of a debt obligation arising out of, the sale of tangible personal property or services (or both) to such issuer or obligor, if

"(A) not less than 30 percent of the purchase price is attributable to the sale of property manufactured, produced, grown, or extracted in the United States by such United States person (or by one or more includible corporations in an affiliated group, as defined in section 1504, of which such person is a member), or to bo performance of services by such United States person (or by one or more such corporations), or to both, and

"(B) not less than 50 percent of the purchase price is attributable to the sale of property manufactured, produced, grown, or extracted in the United States, or to the performance of services by United States persons, or to both.

"(3) EXPORT-RELATED LOANS.—The tax imposed by section 4911 shall not apply to the acquisition from a foreign obligor by a United States person of a debt obligation arising out of a loan made to the obligor to increase or maintain sales of tangible personal property produced, grown, or extracted in the United States by such United States person (or by one or more includible corporations in an affiliated group, as defined in section 1504, of which such person is a member), but only if the proceeds of the loans will be used by the obligor for the installation, maintenance, or improvement of facilities outside the United States which (during the period the loan is outstanding) will be used for the storage, handling, transportation, processing, packaging, or servicing of property a substantial portion of which is tangible personal property produced, grown, or extracted in the United States by such person (or one or more such corporations).

"(4) OTHER LOANS RELATED TO CERTAIN SALES BY UNITED STATES PERSONS.—The tax imposed by section 4911 shall not apply to the acquisition from a foreign obligor by a United States person of a debt obligation of such obligor if such debt obligation—

"(A) was received by such United States person as all or part of the purchase price provided in a contract under which the foreign obligor agrees to purchase for a period of 3 years or more ores or minerals (or derivatives thereof) extracted outside the United States—

"(i) by such United States person;

"(ii) by one or more includible corporations in an affiliated group (as defined in section 48(c)(3)(C)) of which such person is a member; or

"(iii) by a corporation at least 10 percent of the total combined voting power of all classes of stock of which is owned by such United States person, if at least 50 percent of such voting power is owned by United States persons each of whom owns at least 10 percent of such voting power; or

"(B) arises out of a loan (made by such United States person to such foreign obligor) the proceeds of which will be used by such obligor for the installation, maintenance, or improvement of facilities outside the United States which (during the period the loans is outstanding) will be used for the storage, handling, transportation, processing, or servicing of ores or minerals (or derivatives thereof) a substantial portion of which is extracted outside the United States by such United States person or by a corporation referred to in clause (ii) or (iii) of subparagraph (A).

"(5) CROSS REFERENCE.—

"For loss of exclusion otherwise allowable under this subsection in case of certain subsequent transfers, see subsection (g).

"(d) LOANS TO ASSURE RAW MATERIALS SOURCES.—

"(1) GENERAL RULE.—The tax imposed by section 4911 shall not apply to the acquisition by a United States person of a debt obligation arising out of a loan made by such person to a foreign corporation, if—

"(A) such foreign corporation extracts or processes ores or minerals the available deposits of which in the United States are inadequate to satisfy the needs of domestic produces;

"(B) United States persons own at the time of such acquisition at least 50 percent of the total combined voting power of all classes of stock of such foreign corporation, and

"(C) such loan will be amortized under a contract or contracts in which persons owning stock of such corporation (including at least one of the United States persons referred to in subparagraph (B)) agree to pay during the period remaining to maturity of such obligation, by purchasing a part of the production of such corporation or otherwise, a portion of such corporation's costs of operation and costs of amortizing outstanding loans.

"(2) LIMITATION.—The exclusion from tax provided by paragraph (1) shall apply to the acquisition of any debt obligation of a foreign corporation only to the extent that—

"(A) the applicable percentage of (i) the actual value of the debt obligation acquired, plus (ii) the actual value (determined as of the time of such acquisition) of all other debt obligations representing loans which were theretofore made to the foreign corporation during the same calendar year and which are amortizable under contracts of the type described in paragraph (1)(C), exceeds

"(B) the actual value of the debt obligations described in subparagraph (A)(ii) representing loans made by United States persons, to the extent that the acquisition of such obligations was excluded from tax under this subsection.

As used in this paragraph with respect to the acquisition of a debt obligation, the term 'applicable percentage' means the lesser of (i) the percentage of the total combined voting power of all classes of stock of the foreign corporation which is owned by United States persons at the time of such acquisition, or (ii) the percentage of the corporation's operating and amortization costs for the calendar year which all such United States persons have agreed to pay (as of the time of such acquisition) under contracts of the type described in paragraph (1)(C).

"(e) ACQUISITIONS BY INSURANCE COMPANIES DOING BUSINESS IN FOREIGN COUNTRIES.—

"(1) IN GENERAL.—The tax imposed by section 4911 shall not apply to the acquisition of stock or a debt obligation by a United States person which is an insurance company subject to taxation under section 802, 821, or 831, if—

"(A) such stock or debt obligation is designated (in accordance with paragraph (3)) as part of a fund of assets established and maintained by such insurance company (in accordance with paragraph (2)) with respect to foreign risks insured or reinsured by such company under contracts (including annuity contracts) which, by their terms, provide that the proceeds shall be payable only in the currency of a foreign country; and

"(B) the actual value of all of the assets held in such fund immediately after the stock or debt obligation has been designated as a part thereof does not exceed 110 percent of the applicable allowable reserve determined in accordance with paragraph (4).

As used in this subsection, the term 'foreign risks' means risks in connection with property outside, or liability arising out of activity outside, or in connection with the lives or health of residents of countries other than, the United States.

"(2) ESTABLISHMENT AND MAINTENANCE OF FUND OF ASSETS.—Each insurance company which desires to obtain the benefit of exclusions under this subsection shall (as a condition of entitlement to any such exclusion) establish and maintain a fund (or funds) of assets in accordance with this paragraph and paragraph (3). A life insurance company (as defined in section 801(a)) shall establish such a fund of assets separately for each foreign currency (other than the currency of a country which qualifies as a less developed country) in which the proceeds of its insurance contracts are payable and for which insurance reserves are maintained by such company, and with respect to which it desires to obtain the benefits of exclusions under this subsection; and the preceding sentence shall be applied separately to each such fund in determining the company's entitlement to exclude acquisitions of stock and debt obligations designated as a part thereof. An insurance company other than a life insurance company (as so defined) shall establish a single fund of assets for all foreign currencies (other than currencies of countries which qualify as less developed countries at the time of the initial designation) in which the proceeds of its insurance contracts are payable and for which insurance reserves are maintained by such company.

"(3) DESIGNATION OF ASSETS.—

"(A) INITIAL DESIGNATION.—

"(i) REQUIREMENT OF INITIAL DESIGNATION.—An insurance company desiring to establish a fund (or funds) of assets under paragraph (2) shall initially designate, as part or all of such fund (or funds), stock of foreign issuers, or debt obligations of foreign obligors having a period remaining to maturity of 3 years or more,

or both, which it owned on December 10, 1963, to the extent that such stock or debt obligations or both had an actual value as of such date not in excess (in the case of any such fund) of 110 percent of the applicable allowable reserve of such company as determined in accordance with paragraph (4)(A). The designation or designations which an insurance company is required to make under the preceding sentence shall be made first from stock and debt obligations which were acquired by such company on or before July 18, 1963, and shall in no case include any stock or debt obligation described in paragraph (1), (2), or (3) of section 4916(a).

"(ii) TIME AND MANNER OF INITIAL DESIGNATION.—Any initial designation which an insurance company is required to make under this subparagraph shall be made on or before the 30th day after the date of the enactment of this chapter (or at such later time as the Secretary or his delegate may by regulations prescribe) by the segregation on the books of such company of the stock or debt obligations (or both) designated.

"(B) DESIGNATIONS TO MAINTAIN FUND.—To the extent permitted by subparagraph (C), an insurance company may claim an exclusion under this subsection with respect to the acquisition of stock or a debt obligation of a foreign issuer or obligor after December 10, 1963, if such company designates such stock or debt obligation as part of a fund of assets described in paragraph (2) before the expiration of 30 days after the date of such acquisition (and continues to own it until the time the designation is made); except that any such stock or debt obligation acquired before the initial designation of assets to the fund is actually made as provided in subparagraph (A)(ii) may be designated under this subparagraph at the time of such initial designation without regard to such 30-day and continued ownership requirements.

"(C) LIMITATION.—No designation of stock or a debt obligation as part of a fund of assets shall be made under this paragraph to the extent that, immediately thereafter, the actual value of all of the assets held in such fund would exceed 110 percent of the applicable allowable reserve determined in accordance with paragraph (4).

"(4) DETERMINATION OF RESERVES.—

"(A) GENERAL RULE.—For purposes of this subsection, the term 'allowable reserve' means

"(i) in the case of a life insurance company (as defined in section 801(a)), the items taken into account under section 810(c) arising out of contracts of insurance and reinsurance (including annuity contracts) which relate to foreign risks and the proceeds of which are payable in a single foreign currency (other than the currency of a less developed country); and

"(ii) in the case of an insurance company other than a life insurance company (as so defined), the amount of its unearned premiums and unpaid losses which relate to foreign risks insured or reinsured under contracts providing for payment in foreign currencies (other than currencies of less developed countries) and which are taken into account in computing taxable income under section 832(b) (4) and (5) (for such purpose treating underwriting income of an insurance company subject to taxation under section 821 as taxable income under section 832).

The determination of an allowable reserve of an insurance company for any calendar year shall be made as of the close of the previous calendar year.

"(B) SPECIAL ELECTION WITH RESPECT TO DETERMINATION OF ALLOWABLE RESERVE.—Notwithstanding the last sentence of subparagraph (A), an insurance company which has established a fund of assets under this subsection may elect, in such manner and form as the Secretary or his delegate shall by regulations prescribe and at the time it is required under section 6076 to file its return for the period in which the last day of the calendar year occurs, to make the determination of the allowable reserve applicable to such fund with respect to such year as of the close of such year. Upon making such election the company may (if the allowable reserve as so determined is higher than as determined under

subparagraph (A)) designate additional stock or debt obligations (or both) as part of such fund, so long as the company still owns such stock or debt obligations at the time of designation and the actual value of all of the assets held in such fund is not increased to more than 110 percent of the allowable reserve applicable to such fund as determined under this subparagraph. Any tax paid by such company under section 4911 on the acquisition of the additional stock or debt obligations so designated shall constitute an overpayment of tax; and, under regulations prescribed by the Secretary or his delegate, credit or refund (without interest) shall be allowed or made with respect to such overpayment.

"(5) NONRECOGNITION OF ARTIFICAL INCREASES IN ALLOWABLE RESERVE.—An insurance or reinsurance contract which is entered into or acquired by an insurance company for the principal purpose of artificially increasing the amount determined as an allowable reserve as provided in paragraph (4) shall not be recognized in computing whether an acquisition of stock or a debt obligation of a foreign issuer or obligor can be excluded under this subsection.

"(f) ACQUISITIONS BY CERTAIN TAX-EXEMPT LABOR, FRATERNAL, AND SIMILAR ORGANIZATIONS HAVING FOREIGN BRANCHES OR CHAPTERS.—The tax imposed by section 4911 shall not apply to the acquisition of stock or debt obligations by a United States person which is described in section 501(c) and exempt from taxation under subtitle A, and which operates in a foreign country through a local organization or organizations, to the extent that—

"(1) such acquisition results from the investment or reinvestment of contributions or membership fees paid in the currency of such country by individuals who are members of the local organization or organizations, and

"(2) the stock or debt obligations acquired are held exclusively for the benefit of the members of any of such local organizations.

"(g) LOSS OF ENTITLEMENT TO EXCLUSION IN CASE OF CERTAIN SUBSEQUENT TRANSFERS.—

"(1) IN GENERAL.—

"(A) Where an exclusion provided by paragraph (1)(B), (2), (3), or (4) of subsection (c), or the exclusion provided by subsection (d), has applied with respect to the acquisition of a debt obligation by any person, but such debt obligation is subsequently transferred by such person (before the termination date specified in section 4911(d)) to a United States person otherwise than—

"(i) to any agency or wholly-owned instrumentality of the United States;

"(ii) to a commercial bank acquiring the obligation in the ordinary course of its commercial banking business; or

"(iii) in a transaction described in subsection (a) (1) or (2), or a transaction (other than a transfer by gift) described in subsection (a)(3),

then liability for the tax imposed by section 4911 (in an amount determined under subparagraph (D) of this paragraph) shall be incurred by the transferor (with respect to such debt obligation) at the time of such subsequent transfer.

"(B) Where the exclusion provided by paragraph (2) of subsection (c) has applied with respect to the acquisition of stock by any person, but such stock is subsequently transferred by such person (before the termination date specified in section 4911(d)) to a United States person otherwise than in a transaction described in subsection (a) (1) or (2), or a transaction (other than a transfer by gift) described in subsection (a)(3), then liability for the tax imposed by section 4911 (in an amount determined under subparagraph (D) of this paragraph) shall be incurred by the transferor (with respect to such stock) at the time of such subsequent transfer.

"(C) Where the exclusion provided by subsection (f) has applied with respect to the acquisition of stock or a debt obligation by any person, but such stock or debt obligation is subsequently transferred by such person (before the termination date specified in section 4911(d)) to any United States person, then liability for the tax imposed by section 4911 (in an amount determined under subparagraph (D) of this paragraph) shall be incurred by the transferor (with respect to such stock or debt obligation) at the time of such subsequent transfer.

"(D) In any case where an exclusion provided by paragraph (1)(B), (2), (3), or (4) of subsection (c) or by subsection (d) or (f) has applied, but a subsequent transfer described in subparagraph (A), (B), or (C) of this paragraph occurs and liability for the tax imposed by section 4911 is incurred by the transferor as a result thereof, the amount of such tax shall be equal to the amount of tax for which the transferor would have been liable under such section upon his acquisition of the stock or debt obligation involved if such exclusion had not applied with respect to such acquisition.

"(2) UNITED STATES PERSON TREATED AS FOREIGN PERSON ON DISPOSITION OF CERTAIN SECURITIES.—For purposes of this chapter, if, after December 10, 1963, a United States person sells or otherwise disposes of stock or a debt obligation which it—

"(A) acquired to satisfy minimum requirements imposed by foreign law and with respect to which it claimed an exclusion under subsection (b)(3), or

"(B) designated (or was required to designate) as part of a fund of assets under subsection (e),

such person shall not, with respect to that stock or debt obligation, be considered a United States person.

"SEC. 4915. EXCLUSION FOR DIRECT INVESTMENTS.

"(a) IN GENERAL.—

"(1) EXCLUDED ACQUISITIONS.—Except as provided in subsections (c) and (d) of this section, the tax imposed by section 4911 shall not apply to the acquisition by a United States person (A) of stock or a debt obligation of a foreign corporation if immediately after the acquisition such person (or one or more includible corporations in an affiliated group, as defined in section 1504, of which such person is a member) owns (directly or indirectly) 10 percent or more of the total combined voting power of all classes of stock of such foreign corporation, or (B) of stock or a debt obligation of a foreign partnership if immediately after the acquisition such person owns (directly or indirectly) 10 percent or more of the profits interest in such foreign partnership. For purposes of the preceding sentence, stock owned (directly or indirectly) by or for a foreign corporation shall be considered as being owned proportionately by its shareholders, and stock owned (directly or indirectly) by or for a foreign partnership shall be considered as being owned proportionately by its partners.

"(2) OVERPAYMENT WITH RESPECT TO CERTAIN TAXABLE ACQUISITIONS.—The tax paid under section 4911 on the acquisition of stock of a foreign corporation or foreign partnership by a United States person shall (unless this subsection is inapplicable by reason of subsection (c) or (d)) constitute an overpayment of tax if such person continuously holds such stock from the time of its acquisition to the last day of the calendar year in which the acquisition was made and as of such last day meets the ownership requirement of paragraph (1). Under regulations prescribed by the Secretary or his delegate, credit or refund (without interest) shall be allowed or made with respect to such overpayment.

"(b) SPECIAL RULE FOR GOVERNMENT-CONTROLLED ENTERPRISES.—A United States person shall be considered to meet the ownership requirement of subsection (a)(1) with respect to a foreign corporation or a foreign partnership if—

"(1) the government of a foreign country or any political subdivision thereof, or any agency or instrumentality of such a government, directly or indirectly through such corporation or partnership or otherwise, restricts to less than 10 percent the percentage of the total combined voting power of all classes of stock of such corporation, or the percentage of the profits interest in such partnership, which may be owned by such United States person;

"(2) such person owns at least 5 percent of the total combined voting power of so much of such stock, or at least 5 percent of so much of such profits interest, as is not owned by any such government, agency, or instrumentality;

"(3) a trade or business actively conducted in one or more foreign countries by such United States person (or by one or more corporations in an affiliated group, as defined in section 48(c)(3)(C), of which such person is a member) is directly related to the business carried on by such foreign corporation or foreign partnership; and

"(4) such person, and one or more other United States persons each of which satisfies the conditions set forth in paragraphs (2) and (3), together meet the ownership requirement of subsection (a) (1).

"(c) Exception for Foreign Corporations or Partnerships Formed or Availed of for Tax Avoidance.—

"(1) In general.—The provisions of subsections (a) and (b) shall be inapplicable in any case where the foreign corporation or foreign partnership is formed or availed of by the United States person for the principal purpose of acquiring, through such corporation or partnership, an interest in stock or debt obligations (of one or more other foreign issuers or obligors) the direct acquisition of which by the United States person would be subject to the tax imposed by section 4911.

"(2) Commercial banks, underwriters, and required holdings.—For purposes of this subsection, the acquisition by a United States person of stock or debt obligations of a foreign corporation or foreign partnership which acquires stock or debt obligations of foreign issuers or obligors—

"(A) in making loans in the ordinary course of its business as a commercial bank,

"(B) in the ordinary course of its business of underwriting and distributing securities issued by other persons, or

"(C) to satisfy minimum requirements relating to holdings of stock or debt obligations of foreign issuers or obligors imposed by the laws of foreign countries where such foreign corporation or foreign partnership is doing business,

shall not, by reason of such acquisitions by the foreign corporation or foreign partnership, be considered an acquistion by the United States person of an interest in stock or debt obligations of foreign issuers or obligors.

"(3) Loss of entitlement to exclusion of refund where foreign corporation or partnership is availed of for tax avoidance.—In any case where—

"(A) the exclusion provided by subsection (a)(1) has applied with respect to the acquisition of stock or a debt obligation by a United States person, or

"(B) a credit or refund of tax under subsection (a)(2) has been received by a United States person with respect to acquisitions of stock made during a calendar year,

but the foreign corporation or partnership is availed of by such person (after the acquisition described in subparagraph (A) is made or the calendar year described in subparagraph (B) has ended, but before the termination date specified in section 4911(d)) for the principal purpose described in paragraph (1) of this subsection, then liability for the tax imposed by section 4911 shall be incurred by such person (with respect to such stock or debt obligation) at the time the foreign corporation or partnership is so availed of; and the amount of such tax shall be equal (in a case described in subparagraph (A)) to the amount of tax for which such person would have been liable under such section upon his acquisition of the stock or debt obligations involved if such exclusion had not applied to such acquisition, or (in a case described in subparagraph (B)) to the aggregate amount of tax for which such person was liable under such section upon his acquisitions of the stock involved.

"(d) Exception for Acquisitions Made With Intent To Sell to United States Persons.—The provisions of subsections (a) and (b) shall be inapplicable in any case where the acquisition of stock or debt obligations of the foreign corporation or foreign partnership is made with an intent to sell, or to offer to sell any part of the stock or debt obligations acquired to United States persons.

"SEC. 4916. EXCLUSION FOR INVESTMENTS IN LESS DEVELOPED COUNTRIES.

"(a) General Rule.—The tax imposed by section 4911 shall not apply to the acquisition by a United States person of—

"(1) a debt obligation issued or guaranteed by the government of a less developed country or a political subdivision thereof, or by an agency or instrumentality of such a government;

"(2) stock or a debt obligation of a less developed country corporation; or

34–937 O—64——2

"(3) a debt obligation issued by an individual or partnership resident in a less developed country in return for property which is used, consumed, or disposed of wholly within one or more less developed countries.

"(b) LESS DEVELOPED COUNTRY DEFINED.—For purposes of this section, the term 'less developed country' means any foreign country (other than an area within the Sino-Soviet bloc) with respect to which, as of the date of an acquisition referred to in subsection (a), there is in effect an Executive order by the President of the United States designating such country as an economically less developed country for purposes of the tax imposed by section 4911. For purposes of the preceding sentence, Executive Order Numbered 11071, dated December 27, 1962 (designating certain areas as economically less developed countries for purposes of subparts A and F of part III of subchapter N, and section 1248 of part IV of subchapter P, of chapter 1), shall be deemed to have been issued and in effect, for purposes of the tax imposed by section 4911, on July 18, 1963, and continuously thereafter until there is in effect the Executive order referred to in the preceding sentence. An oversea territory, department, province, or possession of any foreign country may be designated as a separate country.

No designation shall be made under this subsection with respect to any of the following:

Australia	Luxembourg
Austria	Monaco
Belgium	Netherlands
Canada	New Zealand
Denmark	Norway
France	Republic of South Africa
Germany (Federal Republic)	San Marino
Hong Kong	Spain
Italy	Sweden
Japan	Switzerland
Liechtenstein	United Kingdom.

After the President (under the first sentence of this subsection) has designated any foreign country as an economically less developed country for purposes of the tax imposed by section 4911, he shall not terminate such designation (either by issuing an Executive order for that purpose or by issuing an Executive order which has the effect of terminating such designation) unless, at least 30 days before such termination, he has notified the Senate and House of Representatives of his intention to terminate such designation.

"(c) LESS DEVELOPED COUNTRY CORPORATION DEFINED.—

"(1) IN GENERAL.—For purposes of this section, the term 'less developed country corporation' means a foreign corporation which for the applicable periods set forth in paragraph (2)—

"(A) meets the requirements of section 955(c) (1) or (2); or

"(B) has gross income 80 percent or more of which is derived from sources within less developed countries, and has assets 80 percent or more in value of which consists of property described in clauses (iii), (iv), and (v) of section 955(c)(1)(B);

except that in applying this paragraph the determination of whether a foreign country is a less developed country shall be made in accordance with subsection (b) of this section.

"(2) APPLICABLE PERIODS.—The determinations required by subparagraphs (A) and (B) of paragraph (1) shall be made (A) for the annual accounting period (if any) of the foreign corporation immediately preceding its accounting period in which the acquisition involved is made, (B) for the annual accounting period of the foreign corporation in which such acquisition is made, and (C) for the next succeeding annual accounting period of the foreign corporation.

"(3) SPECIAL RULES FOR TREATMENT OF CORPORATIONS AS LESS DEVELOPED COUNTRY CORPORATIONS.—A foreign corporation shall be treated as satisfying the definition in paragraph (1) with respect to the acquisition by a United States person of stock or a debt obligation if—

"(A) before the acquisition occurs (or, in the case of an acquisition occurring before or within 60 days after the date of the enactment of this chapter, pursuant to application made within such period following such date as may be prescribed by the Secretary or his

delegate in regulations), it is established to the satisfaction of the Secretary or his delegate that such foreign corporation—

"(i) has met the applicable requirements of paragraph (1) for the period (if any) referred to in paragraph (2)(A), and

"(ii) may reasonably be expected to satisfy such requirements for the periods referred to in paragraph (2) (B) and (C); or

"(B) in the case of an acquisition occurring on or before December 10, 1963, the applicable requirements of paragraph (1) are met for the annual accounting period of the foreign corporation immediately preceding its accounting period in which the acquisition occurred.

"(4) TREATMENT OF CORPORATIONS AS LESS DEVELOPED COUNTRY CORPORATIONS IN OTHER CASES.—A foreign corporation may also be treated as satisfying the definition in paragraph (1) with respect to the acquisition by a United States person of stock or a debt obligation (but subject to possible subsequent liability for tax under subsection (d)(1)), if—

"(A) such corporation has met the applicable requirements of paragraph (1) for the period (if any) referred to in paragraph (2)(A), and

"(B) such person reasonably believes that such corporation will satisfy such requirements for the periods referred to in paragraphs (2) (B) and (C).

"(d) SUBSEQUENT LIABILITY FOR TAX IN CERTAIN CASES.—

"(1) STOCK AND DEBT OBLIGATIONS OF CERTAIN CORPORATIONS.—Where a foreign corporation is treated under subsection (c) (4) as satisfying the definition in subsection (c) (1) and the exclusion provided by subsection (a) (2) has applied with respect to the acquisition of stock or a debt obligation of such corporation by any person, but such corporation fails to satisfy the definition contained in subsection (c) (1) for either of the applicable accounting periods referred to in clauses (B) and (C) of subsection (c)(2) (and it is not treated under subsection (c)(3) as satisfying such definition), then liability for the tax imposed by section 4911 shall be incurred by such person (with respect to such stock or debt obligation) as of the close of the earliest such applicable accounting period (ending on or before the termination date specified in section 4911(d)) with respect to which the corporation fails to satisfy such definition; and the amount of such tax shall be equal to the amount of tax for which such person would have been liable under such section upon the acquisition of the stock or debt obligation involved if such exclusion had not applied with respect to such acquisition.

"(2) DEBT OBLIGATIONS ISSUED IN RETURN FOR CERTAIN PROPERTY.—Where the exclusion provided by subsection (a)(3) has applied with respect to the acquisition by a United States person of a debt obligation issued in return for property as provided in such subsection, but part or all of such property is used, consumed, or disposed of (before the termination date specified in section 5911(d)) otherwise than wholly within one or more less developed countries, then liability for the tax imposed by section 4911 shall be incurred by such person (with respect to such debt obligation) as of the time such property is first so used, consumed, or disposed of; and the amount of such tax shall be equal to the amount of tax for which such person would have been liable under such section upon the acquisition of the debt obligation involved if such exclusion had not applied with respect to such acquisition.

"SEC. 4917. EXCLUSION FOR ORIGINAL OR NEW ISSUES WHERE REQUIRED FOR INTERNATIONAL MONETARY STABILITY.

"(a) IN GENERAL.—If the President of the United States shall at any time determine that the application of the tax imposed by section 4911 will have such consequences for a foreign country as to imperil or threaten to imperil the stability of the international monetary system, he may by Executive order specify that such tax shall not apply to the acquisition by a United States person of stock or a debt obligation of the government of such foreign country or a political subdivision thereof, any agency or instrumentality of any such government, any corporation, partnership, or trust (other than a company registered under the Investment Company Act of 1940) organized under the laws of such country or any such subdivision, or any individual resident therein, to the extent that such stock or debt obligation is acquired as all or

part of an original or new issue as to which there is filed such notice of acquisition as the Secretary or his delegate may prescribe by regulations. In the case of acquisitions made during the period beginning July 19, 1963, and ending with the date of the enactment of this chapter, the notice of acquisition may be filed within such period following the date of such enactment as the Secretary or his delegate may prescribe by regulations.

"(b) APPLICABILITY OF EXECUTIVE ORDER.—An Executive order described in subsection (a) may be applicable to all such original or new issues or to any aggregate amount or classification thereof which shall be stated in such order and shall apply to acquisitions occurring during such period of time as shall be stated therein. If the order is applicable to a limited aggregate amount of such issues it shall apply (under regulations prescribed by the Secretary or his delegate) to those acquisitions as to which notice of acquisition was first filed, provided that in the case of any such notice the acquisition described in the notice is made before or within 90 days after the date of filing.

"(c) ORIGINAL OR NEW ISSUE.—For purposes of this section, a debt obligation shall be treated as part of an original or new issue only if acquired not later than 60 days after the date on which interest begins to accrue on such obligation, and stock shall be treated as part of an original or new issue only when it is acquired from the issuer by the United States person claiming the exclusion.

"SEC. 4918. EXEMPTION FOR PRIOR AMERICAN OWNERSHIP.

"(a) GENERAL RULE.—The tax imposed by section 4911 shall not apply to an acquisition of stock or a debt obligation of a foreign issuer or obligor if it is established by clear and convincing evidence that the person from whom such stock or debt obligation was acquired was a United States person throughout the period of his ownership or continuously since July 18, 1963.

"(b) CERTIFICATE OF AMERICAN OWNERSHIP.—For purposes of subsection (a), a certificate of American ownership received in connection with an acquisition shall be conclusive proof for purposes of this exemption of prior American ownership unless the person making such acquisition has actual knowledge that the certificate is false in any material respect.

"(c) TRADING ON CERTAIN NATIONAL SECURITIES EXCHANGES.—For purposes of subsection (a), a written confirmation received from a member or member organization of a national securities exchange registered with the Securities and Exchange Commission stating that an acquisition was made in the regular market on such exchange (and not subject to a special contract) shall be conclusive proof for purposes of this exemption of prior American ownership (unless the person making such acquisition has actual knowledge that the confirmation is false in any material respect), if such exchange has in effect at the time of the acquisition rules providing that—

"(1) any stock or debt obligation, the acquisition of which by any United States person would be subject to the tax imposed by section 4911 but for the provisions of this section, shall be sold in the regular market on such exchange (and not subject to a special contact) only if the member or member organization of such exchange who effects the sale of such stock or debt obligation as broker has in his possession (A) a certificate of American ownership with respect to the stock or debt obligation sold, or (B) a blanket certificate of American ownership with respect to the account for which such stock or debt obligation is sold; and

"(2) any member or member organization of such exchange effecting as broker a purchase of any such stock or debt obligation subject to a special contract (and not in the regular market) shall furnish the person making such an acquisition a written confirmation stating that the acquisition was made subject to such special contract.

"(d) TRADING IN THE OVER-THE-COUNTER MARKET.—For purposes of subsection (a), a written confirmation from a member or member organization of a national securities association registered with the Securities and Exchange Commission received in connection with an acquisition made other than on a national securities exchange described in subsection (c) shall be conclusive proof for purposes of this exemption of prior American ownership, unless the confirmation states that the acquisition was made from a person who has not executed and filed a certificate of American ownership with respect to the stock or debt obligation sold or a blanket certificate of American ownership with respect to the account from which the stock or debt obligation is sold (or the person making such acquisition has actual knowledge that the confirmation is false in any material

respect), if such association has in effect at the time of the acquisition rules providing that any member or member organization of such association who effects a sale as broker other than on a national securities exchange of any stock or debt obligation, the acquisition of which by any United States person would be subject to the tax imposed by section 4911 but for the provisions of this section, must—

"(1) have in his possession (A) a certificate of American ownership with respect to the stock or debt obligation sold, or (B) a blanket certificate of American ownership with respect to the account for which such stock or debt obligation is sold; or

"(2) furnish to the person acquiring such stock or debt obligation written confirmation stating that the acquisition is from a person who has not executed and filed a certificate of American ownership with respect to such stock or debt obligation or a blanket certificate of American ownership with respect to the account from which such stock or debt obligation is sold.

Any member or member organization of such an association who acquires any stock or debt obligation for his or its own account other than on a national securities exchange may treat a blanket certificate of American ownership with respect to the seller's account as conclusive proof for purposes of this exemption of prior American ownership, unless such member or member organization has actual knowledge that such certificate is false in any material respect.

"(e) EXECUTION, FILING, AND CONTENTS OF CERTIFICATE.—A certificate of Amercan ownership or blanket certificate of American ownership under this section must be executed and filed in such manner and set forth such information as the Secretary or his delegate shall prescribe by regulations.

"SEC. 4919. SALES BY UNDERWRITERS AND DEALERS TO FOREIGN PERSONS.

"(a) CREDIT OR REFUND.—The tax paid under section 4911 on the acquisition of stock or debt obligations of a foreign issuer or obligor shall constitute an overpayment of tax to the extent that such stock or debt obligations—

(1) PRIVATE PLACEMENTS.—Are acquired by an underwriter from the foreign issuer or obligor (or from a person or persons controlling, controlled by, or under common control with such issuer or obligor) and are sold directly by the underwriter to persons other than United States persons in transactions not involving a public offering;

"(2) PUBLIC OFFERINGS.—Are acquired by an underwriter for distribution in connection with a public offering by a foreign issuer or obligor (or a person or persons controlling, controlled by, or under common control with such issuer or obligor) and are sold as part of such public offering by the underwriter (including sales by other United States persons participating in the distribution of the stock or debt obligations acquired by the underwriter) to persons other than United States persons; or

"(3) CERTAIN DEBT OBLIGATIONS.—Consist of debt obligations acquired by a dealer in the ordinary course of his business and sold by the dealer to persons other than United States persons within 90 days after (or, in the case of short sales, within 90 days before) their acquisition.

Under regulations prescribed by the Secretary or his delegate, credit or refund (without interest) shall be allowed or made with respect to such overpayment.

"(b) EVIDENCE TO SUPPORT CREDIT OR REFUND.—An underwriter or dealer claiming credit or refund under this section shall file with the return required by section 6011(d) on which credit is claimed, or with the claim for refund, such information as the Secretary or his delegate may by regulations prescribe. Credit or refund shall not be allowed with respect to stock or debt obligations sold by a United States person participating in the distribution of the stock or debt obligations acquired by an underwriter unless the underwriter establishes by clear and convincing evidence that such stock or debt obligations were sold to persons other than United States persons. For purposes of the preceding sentence, a certificate of sales to foreign persons (executed in such manner by the United States person making such sales, filed in such manner, and setting forth such information, as the Secretary or his delegate may by regulations prescribe) shall be conclusive proof for purposes of the credit or refund that such sales were made to a person other than a United States person unless the underwriter relying upon the certificate has actual knowledge that the certificate is false in any material respect. In any case where two or more underwriters form a group for the purpose of purchasing and distributing (through

resale) stock or debt obligations of a single foreign issuer or obligor, the filing of a certificate of sales to foreign persons by any one of such underwriters may, to the extent provided by regulations prescribed by the Secretary or his delegate, constitute the filing of such certificate for all of such underwriters.

"(c) DEFINITIONS.—For purposes of this section—

"(1) the term 'underwriter' means any person who has purchased stock or debt obligations from the issuer or obligor (or from a person controlling, controlled by, or under common control with such issuer or obligor), or from another underwriter, with a view to the distribution through resale of such stock or debt obligations; and

"(2) the term 'dealer' means any person who is a member of the National Association of Securities Dealers and who is regularly engaged, as a merchant, in purchasing stock or debt obligations and selling them to customers with a view to the gains and profits which may be derived therefrom.

"SEC. 4920. DEFINITIONS.

"(a) IN GENERAL.—For purposes of this chapter—

"(1) DEBT OBLIGATION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'debt obligation' means—

"(i) any indebtedness, whether or not represented by a bond, debenture, note, certificate, or other writing, whether or not secured by a mortgage, and whether or not bearing interest; and

"(ii) any interest in, or any option or similar right to acquire, a debt obligation referred to in this subparagraph, whether or not such interest, option, or right is in writing.

"(B) EXCEPTIONS.—The term 'debt obligation' shall not include any obligation which—

"(i) is convertible by its terms into stock of the obligor, if it is so convertible only within a period of 5 years or less from the date on which interest begins to accrue thereon; or

"(ii) arises out of the divorce, separate maintenance, or support of an individual who is a United States person.

"(2) STOCK.—The term 'stock' means—

"(A) any stock, share, or other capital interest in a corporation;

"(B) any interest of a partner in a partnership;

"(C) any interest in an investment trust;

"(D) any indebtedness which is convertible by its terms into stock of the obligor, if it is so convertible only within a period of 5 years or less from the date on which interest begins to accrue thereon; and

"(E) any interest in, or option or similar right to acquire, any stock described in this paragraph.

"(3) FOREIGN ISSUER OR OBLIGOR.—The terms 'foreign issuer', 'foreign obligor', and 'foreign issuer or obligor' mean any issuer of stock or obligor of a debt obligation, as the case may be, which is—

"(A)(i) an international organization of which the United States is not a member,

"(ii) the government of a foreign country or any political subdivision thereof, or an agency or instrumentality of such a government,

"(iii) a corporation, partnership, or estate or trust which is not a United States person as defined in paragraph (4); or

"(iv) a nonresident alien individual;

"(B) a domestic corporation which, as of July 18, 1963, was a management company registered under the Investment Company Act of 1940 if—

"(i) at least 80 percent of the value of the stock and debt obligations owned by such corporation on July 18, 1963, and at least 80 percent of the value of the stock and debt obligations owned by such corporation at the end of every calendar quarter thereafter (through the quarter preceding the quarter in which the acquisition involved is made), consists of stock or debt obligations of foreign issuers or obligors and other debt obligations having an original maturity of 90 days or less;

"(ii) such corporation elects to be treated as a foreign issuer or obligor for purposes of this chapter; and

"(iii) such corporation does not materially increase its assets during the period from July 18, 1963, to the date of such election through borrowing or through issuance or sale of its stock (other than stock issued or sold on or before September 16, 1963, as part of a public offering with respect to which a registration statement was first filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days before that date).

The election under clause (ii) shall be made on or before the 60th day after the date of the enactment of this chapter under regulations prescribed by the Secretary or his delegate. Such election shall be effective as of the date specified by the corporation, but not later than the date on which such election is made, and shall remain in effect until revoked. If, at the close of any succeeding calendar quarter, the company ceases to meet the requirement of clause (i), the election shall thereupon (with respect to quarters after such calendar quarter) be deemed revoked. When an election is revoked no further election may be made. If the assets of a foreign corporation are acquired by a domestic corporation in a reorganization described in subparagraph (D) or (F) of section 368(a)(1), the two corporations shall be considered a single domestic corporation for purposes of this subparagraph.

A foreign corporation (other than a company registered under the Investment Company Act of 1940) shall not be considered a foreign issuer with respect to any class of its stock which is traded on one or more national securities exchanges registered with the Securities and Exchange Commission, if the trading on such national securities exchanges constituted the principal market for such class of stock during the calendar year 1962 and if, as of the latest record date before July 19, 1963, more than 50 percent of such class of stock was held of record by United States persons.

"(4) United states person.—The term 'United States person' means—

"(A) a citizen or resident of the United States,

"(B) a domestic partnership,

"(C) a domestic corporation, other than a corporation described in paragraph (3)(B),

"(D) an agency or wholly-owned instrumentality of the United States,

"(E) a State or political subdivision, or any agency or instrumentality thereof, and

"(F) any estate or trust—

"(i) the income of which from sources without the United States is includible in gross income under subtitle A (or would be so includible if not exempt from tax under section 501(a), section 521(a), or section 521(a), or section 584(b)), or

"(ii) which is situated in the Commonwealth of Puerto Rico or a possession of the United States.

"(5) Domestic corporation; domestic partnership.—The terms 'domestic corporation' and 'domestic partnership' mean, respectively, a corporation or partnership created or organized in the United States or under the laws of the United States or of any State.

"(6) United states; state.—The term 'United States' when used in a geographical sense includes the States, the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States; and the term 'State' includes the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States.

"(7) Period remaining to maturity.—

"(A) In general.—Subject to the modifications set forth in subparagraph (B), the period remaining to maturity of a debt obligation shall be that period beginning on the date of its acquisition and ending on the fixed or determinable date when, according to its terms, the payment of principal becomes due.

"(B) Modifications.—The period remaining to maturity—

"(i) of any interest in, or any option or similar right to acquire, any debt obligation shall be the period remaining to maturity of that debt obligation at the time of the acquisition of such interest, option, or right;

"(ii) of any debt obligation which is renewable without affirmative action by the obligee, or of any interest in or option or similar right to acquire such a debt obligation, shall end on the last day of the final renewable period;

"(iii) of any debt obligation which has no fixed or determinable date when the payment of principal becomes due shall be considered to be 28½ years;

"(iv) of any debt obligation which is payable on demand shall be considered to be less than 3 years; and

"(v) of a debt obligation which is subject to retirement before its maturity through operation of a mandatory sinking fund shall be determined under regulations prescribed by the Secretary or his delegate.

"(b) CROSS REFERENCE.—

"For definition of 'acquisition', see section 4912."

(b) TECHNICAL AMENDMENT.—The table of chapters for subtitle D is amended by adding at the end thereof the following item:

"Chapter 41. Interest equalization tax."

(c) EFFECTIVE DATE.—

(1) GENERAL RULE.—Except as provided by paragraphs (2), (3), (4), (5), (6), and (7), the amendments made by this section shall apply with respect to acquisitions of stock and debt obligations made after July 18, 1963.

(2) PREEXISTING COMMITMENTS.—Such amendments shall not apply to an acquisition—

(A) made pursuant to an obligation to acquire which on July 18, 1963—

(i) was unconditional, or

(ii) was subject only to conditions contained in a formal contract under which partial performance had occurred;

(B) as to which on or before July 18, 1963, the acquiring United States person (or, in a case where 2 or more United States persons are making acquisitions as part of a single transaction, a majority in interest of such persons) had taken every action to signify approval of the acquisition under the procedures ordinarily employed by such person (or persons) in similar transactions and had sent or deposited for delivery to the foreign issuer or obligor written evidence of such approval in the form of a commitment letter, memorandum of terms, or other signed document setting forth the principal terms of such acquisition, subject only to the execution of formal documents evidencing the acquisition and to customary closing conditions; or

(C) which would be excluded from tax under section 4915 of the Internal Revenue Code of 1954 but for the provisions of subsection (c) thereof, if (i) on or before July 18, 1963, the acquiring United States person applied for and received from a foreign government (or an agency or instrumentality thereof) authorization to make such acquisition and approval of the amount thereof, and (ii) such authorization was required in order for such acquisition to be made.

(3) PUBLIC OFFERING.—Such amendments shall not apply to an acquisition made on or before September 16, 1963, if—

(A) a registration statement (within the meaning of the Securities Act of 1933) was in effect with respect to the stock or debt obligation acquired at the time of its acquisition;

(B) the registration statement was first filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days before that date; and

(C) no amendment was filed with the Securities and Exchange Commission after July 18, 1963, and before the acquisition which had the effect of increasing the number of shares of stock or the aggregate face amount of the debt obligations covered by the registration statement.

(4) INVESTMENT OF PROCEEDS OF SUBSCRIPTION OFFERING.—Such amendments shall not apply to an acquisition of stock or debt obligations of a foreign issuer or obligor by a corporation electing under section 4920(a)(3)(B) of the Internal Revenue Code of 1954 to be treated as a foreign issuer or obligor for purposes of chapter 41 of such Code, to the extent that the amount of consideration paid for all such stock and debt obligations does

not exceed the proceeds received by such corporation from a subscription offering (completed on or before September 16, 1963) as to which a registration statement was filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days before that date.

(5) LISTED SECURITIES.—Such amendments shall not apply to an acquisition made on or before August 16, 1963, if the stock or debt obligation involved was acquired on a national securities exchange registered with the Securities and Exchange Commission.

(6) OPTIONS AND FORECLOSURES.—Such amendments shall not apply to an acquisition—

(A) of stock pursuant to the exercise of an option or similar right (or a right to convert a debt obligation into stock), if such option or right was held on July 18, 1963, by the person making the acquisition or by a decedent from whom such person acquired the right to exercise such option or right by bequest or inheritance or by reason of such decedent's death, or

(B) of stock or debt obligations as a result of a foreclosure by a creditor pursuant to the terms of an instrument held by such creditor on July 18, 1963.

(7) DOMESTICATION.—Such amendments shall not apply to the acquisition by a domestic corporation of the assets of a foreign corporation pursuant to a reorganization described in subparagraph (D) or (F) of section 368(a)(1) of the Internal Revenue Code of 1954 if the acquisition occurs on or before the 180th day after the date of the enactment of this Act and the foreign corporation was a management company registered under the Investment Company Act of 1940 from July 18, 1963, until the time of the acquisition.

(8) MEANING OF TERMS.—Terms used in this subsection (except as specifically otherwise provided) shall have the same meaning as when used in chapter 41 of the Internal Revenue Code of 1954.

SEC. 3. RETURNS.

(a) MAKING OF RETURNS.—Section 6011 (relating to general requirements of return, statement, or list) is amended by redesignating subsection (d) as subsection (e), and by adding after subsection (c) the following new subsection:

"(d) INTEREST EQUALIZATION TAX RETURNS, ETC.—

"(1) IN GENERAL.—Every person shall make a return for each calendar quarter during which he incurs liability for the tax imposed by section 4911, or would so incur liability but for the provisions of section 4918. The return shall, in addition to such other information as the Secretary or his delegate may by regulations require, include a list of all acquisitions made by such person during the calendar quarter which are exempt under the provisions of section 4918, and shall be accompanied by clear and convincing evidence showing that the acquisitions are so exempt. No return or accompanying evidence shall be required under this paragraph in connection with any acquisition with respect to which a written confirmation, furnished in accordance with the requirements described in section 4918 (c) or (d), is treated as conclusive proof of prior American ownership; nor shall any such acquisition be required to be listed in any return made under this paragraph.

"(2) INFORMATION RETURNS OF COMMERCIAL BANKS.—Every United States person (as defined in section 4920(a)(4)) which is a commercial bank shall file a return with respect to loans and commitments to foreign obligors at such times, in such manner, and setting forth such information as the Secretary or his delegate shall by forms and regulations prescribe.

"(3) REPORTING REQUIREMENTS FOR MEMBERS OF EXCHANGES AND ASSOCIATIONS.—Members of member organizations of national securities exchanges and national securities associations registered with the Securities and Exchange Commission shall keep such records and file such information as the Secretary or his delegate may by regulations prescribe in connection with sales effected by such members or member organizations as brokers, and acqusitions made for their own accounts, of stock or debt obligations as to which a certificate of American ownership or blanket certificate of American ownership is executed and filed as described in section 4918(e)."

(b) TIME FOR FILING RETURNS.—Part V of subchapter A of chapter 61 (relating to time for filing returns and other documents) is amended by adding at the end thereof the following new section:

"SEC. 6076. TIME FOR FILING INTEREST EQUALIZATION TAX RETURNS.

"Each return made under section 6011(d)(1) (relating to interest equalization tax) shall be filed on or before the last day of the first month following the period for which it is made."

(c) PUBLICITY OF RETURNS.—Section 6103(a)(2) (relating to public record and inspection) is amended by striking out "and subchapter B of chapter 37" and inserting in lieu thereof "subchapter B of chapter 37, and chapter 41".

(d) CLERICAL AMENDMENT.—The table of sections for part V of subchapter A of chapter 61 is amended by adding at the end thereof the following:

"Sec. 6076. Time for filing interest equalization tax returns."

(e) FIRST RETURN PERIOD.—Notwithstanding any provision of section 6011(d)(1) of the Internal Revenue Code of 1954, the first period for which returns shall be made under such section 6011(d)(1) shall be the period commencing July 19, 1963, and ending at the close of the calendar quarter in which the enactment of this Act occurs.

SEC. 4. DISALLOWANCE OF DEDUCTION FOR AMOUNT PAID AS INTEREST EQUALIZATION TAX.

Section 263(a) (relating to capital expenditures) is amended by adding at the end thereof the following new paragraph:

"(3) Any amount paid as tax under section 4911 (relating to imposition of interest equalization tax) except to the extent that any amount attributable to the amount paid as tax is included in gross income for the taxable year."

SEC. 5. PENALTIES.

(a) ASSESSABLE PENALTIES.—Subchapter B of chapter 68 (relating to assessable penalties) is amended by adding at the end thereof the following new sections:

"SEC. 6680. FAILURE TO FILE INTEREST EQUALIZATION TAX RETURNS.

"In addition to the penalty imposed by section 7203 (relating to willful failure to file return, supply information, or pay tax), any person who is required under section 6011(d)(1) (relating to interest equalization tax returns) to file a return for any period in respect of which, by reason of the provisions of section 4918, he incurs no liability for payment of the tax imposed by section 4911, and who fails to file such return within the time prescribed by section 6076, shall pay a penalty of $10 or 5 percent of the amount of tax for which he would incur liability for payment under section 4911 but for the provisions of section 4918, whichever is the greater, for each such failure unless it is shown that the failure is due to reasonable cause. The penalty imposed by this section shall not exceed $1,000 for each failure to file a return.

"SEC. 6681. FALSE EQUALIZATION TAX CERTIFICATES.

"(a) FALSE CERTIFICATE OF AMERICAN OWNERSHIP.—In addition to the criminal penalty imposed by section 7241, any person who willfully executes a certificate of American ownership or blanket certificate of American ownership described in section 4918(e) which contains a misstatement of material fact shall be liable to a penalty equal to 125 percent of the amount of tax imposed by section 4911 on the acquisition of the stock or debt obligation involved which, but for the provisions of section 4918, would be payable by the person acquiring the stock or debt obligation.

"(b) LIABILITY OF MEMBERS OF NATIONAL SECURITIES EXCHANGES AND ASSOCIATIONS.—A member or member organization of a national securities exchange described in section 4918(c) or a national securities association described in section 4918(d) shall be liable to a penalty equal to 125 percent of the amount of tax imposed by section 4911 on the acquisition (in a transaction subject to the rules of such exchange or association as described in section 4918 (c) or (d)) of stock or a debt obligation which but for the provisions of section 4918, would be payable by the person acquiring the stock or debt obligation, if such member—

"(1) willfully effects the sale of such stock or debt obligation or furnishes a written confirmation with respect to the purchase or sale of such stock or debt obligation other than in accordance with the requirements described in section 4918 (c) or (d) ; or

"(2) has actual knowledge that—

"(A) the certificate of American ownership or the blanket certificate of American ownership (referred to in section 4918) in his possession in connection with the sale of such stock or debt obligation is false in any material respect; or

"(B) the person who executed and filed the blanket certificate of American ownership in his possession was not a United States person at the time of sale.

"(c) FALSE CERTIFICATE OF SALES TO FOREIGN PERSONS.—In addition to the criminal penalty imposed by section 7241, any person who willfully executes a certificate of sales to foreign persons described in section 4919(b) which contains a misstatement of material fact shall be liable to a penalty equal to 125 percent of the amount of the tax imposed by section 4911 on the acquisition of the stock or debt obligation involved which, but for the provisions of section 4919(b), would be payable by the underwriter acquiring the stock or debt obligation.

"(d) PENALTY TO BE IN LIEU OF TAX IN CERTAIN CASES.—Unless the person acquiring the stock or debt obligation involved had actual knowledge that the certificate was false in any material respect, the penalty under subsection (a) or (c) shall be in lieu of any tax on the acquisition of such stock or debt obligation under section 4911."

(b) CRIMINAL PENALTY.—Part II of subchapter A of chapter 75 (relating to penalties applicable to certain taxes) is amended by adding at the end thereof the following new section:

"SEC. 7241. PENALTY FOR FRAUDULENT EQUALIZATION TAX CERTIFICATES.

"Any person who willfully executes a certificate of American ownership or blanket certificate of American ownership described in section 4918(e), or a certificate of sales to foreign persons described in section 4919(b), which is known by him to be fraudulent or to be false in any material respect shall be guilty of a misdemeanor and, upon conviction thereof, shall for each offense be fined not more than $1,000, or imprisoned not more than 1 year, or both."

(c) CLERICAL AMENDMENTS.—

(1) The table of sections for subchapter B of chapter 68 is amended by adding at the end thereof the following:

"Sec. 6680. Failure to file interest equalization tax returns.
"Sec. 6681. False equalization tax certificates."

(2) The table of sections for part II of subchapter A of chapter 75 is amended by adding at the end thereof the following:

"Sec. 7241. Penalty for fraudulent equalization tax certificates."

Passed the House of Representatives March 5, 1964.

RALPH R. ROBERTS,
Clerk.

THE SECRETARY OF THE TREASURY,
Washington D.C., June 12, 1964.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: I am transmitting with this letter a series of proposed amendments recommended by the Treasury Department to the proposed interest equalization tax bill (H.R. 8000). This bill occupies a central position in our total effort to achieve prompt and lasting improvement in our balance of payments by reducing the flow of long-term portfolio capital from this country. The purposes of the bill are achieved through the imposition of a temporary excise tax on the acquisition from foreigners of foreign stocks or debt obligations with maturities of 3 years or more.

The proposed amendments are fully consistent with the principles of the bill as passed by the House. The changes embodied in these amendments are directed at technical problems which have been raised since House passage of H.R. 8000 and are designed for the most part to extend or clarify exclusions contained in the House bill, without at the same time weakening the effectiveness of the proposed legislation.

The Treasury Department believes it would be helpful to have these proposed amendments made public at this time by your committee. Publication of the amendments would enable interested persons to learn the Treasury's views on the various questions which have been brought to our attention since House passage of the legislation. This will permit them to focus on the proposed amendments in framing any comments they may wish to submit in connection with the bill.

Sincerely yours,

DOUGLAS DILLON.

SUGGESTED AMENDMENTS TO THE INTEREST EQUALIZATION TAX BILL (H.R. 8000) PROPOSED BY THE TREASURY DEPARTMENT

GENERAL EXPLANATION

The Treasury Department recommends that the interest equalization tax bill (H.R. 8000) be amended in accordance with the proposed changes described in this statement. The bill is designed to relieve pressure on the balance of payments by bringing the cost of portfolio capital raised in the U.S. market by foreign persons more closely into alinement with the costs prevailing in markets in other industrial countries. This purpose would be achieved by imposing a temporary tax on acquisitions by Americans of certain foreign securities from foreigners. The suggested amendments are fully consistent with the intent of the bill as passed by the House and do not depart from the basic provisions and framework of that bill.

In general, the changes resolve technical problems which have been brought to the attention of the Treasury during the period since House passage of H.R. 8000. Some of the suggested amendments modify and extend certain exclusions so that the purposes of the bill may be achieved without unnecessarily impeding use of normal sources or techniques of financing. Other amendments simply clarify existing provisions and provide for more effective administration of the proposed tax.

EXPORT PROVISIONS

Amendments are being proposed to expand the export provisions of the bill, in order to give further assurance that the tax does not interfere with the legitimate export financing of U.S. goods and services. One proposed change extends the exclusion for stock and debt obligations arising from the sale of property produced in the United States to intangible property (such as patents and copyrights) as well as tangible property. A second proposed amendment liberalizes the rule permitting an exporter to transfer free of the tax a debt obligation received in the financing of U.S. exports. Another change makes clear that the exclusion provided by the bill where payment of an export loan is guaranteed or insured in whole or in part by the Export-Import Bank, remains available even if the loan gives rise to separate obligations.

The suggested amendments propose an extension of the exclusion contained in the bill for loans made in connection with the sale of ores or minerals extracted outside the United States. The categories of corporations which qualify as extractive companies would be broadened, and ores or minerals obtained under a contract entered into on or before July 18, 1963, would be covered by the provision. These changes recognize additional situations in which U.S. persons have a substantial economic interest in the extracted ore or mineral.

INSURANCE COMPANY PROVISIONS

A series of changes are suggested in the provisions dealing with insurance companies doing business in foreign countries so as to clarify those provisions and to perfect their technical application. Under the proposed amendments, insurance companies are permitted to include short-term obligations payable in foreign currency within their initial designation of exempt funds of assets of foreign securities, and to use the adjusted basis of the securities, rather than actual value, as the means of valuing the funds. The amendments require the companies to fill up their designated funds of exempt assets annually to the limit provided in the bill, to the extent of purchases made during the calendar year of stock and debt obligations otherwise excluded from tax under the new issue exclusion of section 4917 and the less-than-3-year exemption. The amendments also clarify the method of determining a company's allowable reserve for the year 1963, and permit insurance companies for purposes of determining the size of the designated funds to estimate the growth in their foreign business during a year. This will avoid the necessity of paying tax throughout the year on acquisitions in excess of the size of the fund at the end of the previous year, and claiming a credit or refund at the end of the year.

ADDITIONAL EXCLUSIONS

Amendments are being proposed which exclude certain types of acquisitions from tax. The proposed new exclusions include provisions relating to acquisitions of stock and debt obligations in lieu of payment of foreign tax; purchases of stock in order to obtain the right to occupy a dwelling; and acquisitions of obligations received in connection with the sale of a wholly owned foreign subsidiary. Acquisitions of these types are due to factors other than the relative return on capital between the United States and foreign countries. It is also proposed that the tax not apply to the acquisition of a debt obligation which is part of the purchase price of real property located in the United States, if the foreign buyer pays at least 25 percent of the purchase price to the American seller in U.S. dollars. Such a transaction has a favorable impact on the U.S. balance of payments and the exclusion is fully consistent with the purposes of the legislation.

DIRECT INVESTMENT

The changes in this section are designed to permit broader use of the direct investment exclusion. One change permits a U.S. corporation holding a 10-percent or more interest in a foreign corporation to acquire from the foreign corporation debt obligations which had previously been acquired by the foreign corporation in the ordinary course of its business as a result of the sale or rental of products manufactured or assembled by it or the performance of services by it. This form of financing is an alternative to a direct investment by the U.S. parent corporation in its foreign subsidiary. The suggested amendments also make available a credit or refund on purchases where a 10-percent or more interest is acquired over a 12-month period, whether or not the period coincides with a particular calendar year. In these situations, the credit or refund is made available with respect to debt obligations as well as stock.

LESS DEVELOPED COUNTRIES

The amendments propose that the less developed country provisions be expanded to permit the tax-free acquisition of stock and debt obligations by a U.S. person who is required to reinvest in a less developed country the payments received under a contract of sale (or indemnification) with the less developed country, resulting from the actual or threatened expropriation, nationalization, or seizure of the U.S. person's property in that country. Under such circumstances, the companies in which the U.S. person is required to invest presumably would qualify as less developed country corporations, but the conditions under which the investments are required to be made may make it impossible for the U.S. person to obtain the requisite proof.

Changes are also proposed in the provision defining a "less developed country corporation" to expand the number of companies which would qualify under the provision. The amendments are directed primarily at corporations doing business in less developed countries which may hold U.S. assets, obligations of individuals resident in less developed countries, or assets temporarily in foreign bank accounts (other than in less developed countries).

EXCLUSION FOR NEW ISSUES WHERE REQUIRED FOR INTERNATIONAL MONETARY STABILITY

One of the suggested amendments in this section clarifies the definition of what constitutes a new issue of debt obligations for purposes of this exclusion to make clear that construction loans are eligible to qualify. The other proposed change is designed to facilitate procedural operation of the exclusion by authorizing the President to extend the period of time within which an acquisition must be made after filing of the required notice.

SALES BY UNDERWRITERS AND DEALERS

One of the suggested amendments in the provisions of the bill dealing with transactions by underwriters and dealers permits a foreign underwriter participating in a public offering in the United States with American underwriters to elect to be treated as a U.S. person for purposes of his participation in the offering. This change will facilitate uniform pricing of the offering and eliminate return filing burdens for U.S. purchasers acquiring from the foreign underwriter.

The suggested amendments also permit a dealer to claim a credit or refund on the sale of debt obligations to foreigners within 90 days of purchase if the obligations are sold to another dealer who in turn sells to a foreigner on the date of purchase or the next business day. This change recognizes certain trading practices in the securities industry. The amendments also authorize the establishment of procedures by the stock exchanges and the over-the-counter market to provide a dealer with proof that the security was sold to a foreign person. Appropriate penalties are provided in the bill if these procedures are abused.

The proposed changes also permit a credit if a dealer acquires foreign stock in the ordinary course of his business and sells the stock on the

same business day to a foreigner. This proposal is designed to permit dealers to conduct certain types of arbitrage activities without at the same time weakening the effectiveness of the tax.

LIMITATIONS ON TAX

Three amendments are suggested in the section of the bill which limits the tax imposed on certain acquisitions so as to expand the situations in which the special rules limiting application of the tax may be utilized. The first of these permits an American who acquires a debt obligation from another American (free of the tax) and who later exercises the right to convert the debt obligation into stock to offset against his liability the amount of tax which would have been imposed if the obligation had been acquired in a taxable transaction. The bill now permits an offset only with respect to tax which was actually paid on acquisition of the obligation. A second change permits an American, exercising a subscription right to acquire stock or a debt obligation within 90 days from the date of the distribution of the rights, to use the exercise price as his tax base, whether or not he was the original distributee of the rights. The bill presently limits use of the exercise price to the original recipient of the rights from the issuer. The third amendment avoids the possibility of a double tax where a domestic corporation has been formed or availed of for the benefit of a foreign borrower.

PREEXISTING COMMITMENTS

The suggested amendments propose a liberalization of the provisions in the bill exempting certain transactions from the generally effective date of the tax of July 19, 1963, because of the existence of a preexisting commitment. They extend the exemption to situations where application of the tax might involve hardship to the parties because of the advanced state of negotiations on July 18, 1963. An exemption is also provided if the acquisition was pursuant to a contract of sale to a less developed country entered into on or before July 18, 1963, if the contract requires reinvestment of the proceeds in that country.

ORIGINAL ISSUE DISCOUNT

The proposed amendments suggest a change in the provisions of the Internal Revenue Code dealing with the taxation of the difference between the issue price of bonds and the stated redemption price at maturity of such bonds, i.e., "original issue discount." The amendment is designed to prevent the interest equalization tax from creating adverse income tax consequences in the case of private placements of bonds.

ADMINISTRATIVE PROVISIONS

The proposed amendments provide that proof of the exemption for prior American ownership must be in the form of a certificate of American ownership or a confirmation received from a member of a registered exchange or the National Association of Securities Dealers, unless reasonable cause is submitted for the inability to produce such evidence. This technical change is needed because of other pro-

visions already contained in the bill which are designed to facilitate trading in foreign securities. In the overwhelming majority of purchases of foreign securities, a confirmation will be received by the American buyer which satisfies the requirements of the bill, and no return or filing is necessary. However, if no confirmation or certificate is obtained or submitted, a person claiming the exemption for prior American ownership must file a statement explaining his inability to submit the certificate, together with a summary of the evidence establishing the exemption.

A second proposed administrative change relates to required recordkeeping and information filing by members of stock exchanges and the National Association of Securities Dealers. The present bill requires recordkeeping and the filing of information by the seller's broker in transactions where the exemption for prior American ownership is claimed, since the action of the seller's broker in accepting a certificate of American ownership results in no tax being due from the purchaser. The suggested amendments apply recordkeeping and filing requirements to transactions in which no exemption is available (and tax is due), since such records and information are essential to facilitate enforcement of the tax.

34-937 O—64——3

PROPOSED AMENDMENTS AND TECHNICAL EXPLANATION

Section 4913. LIMITATION ON TAX ON CERTAIN ACQUISITIONS

(a) CERTAIN SURRENDERS, EXTENSIONS, RENEWALS, AND EXERCISES. Page 7, line 7.

(3) SPECIAL LIMITATIONS. Page 8, line 19.

(A) CONVERSIONS OF DEBT OBLIGATIONS INTO STOCK. Page 8, line 20.

This subparagraph should be amended to read as follows:

> "The tax imposed upon an acquisition of stock pursuant to the exercise of a right to convert a debt obligation (as defined in section 4920(a)(1)) into stock shall be limited to—
>
> "(i) the amount of tax which would have been imposed by section 4911 if the debt obligation [pursuant to section 4920(a)(2)(D),] had been treated as stock at the time of its acquisition by the person exercising the right (or by a decedent from whom such person acquired the right by bequest or inheritance or by reason of such decedent's death), less
>
> "(ii) the amount of tax paid by the person exercising the right (or by such decedent) as a result of the acquisition of the convertible debt obligation *or, if such acquisition was not subject to the tax imposed by section 4911, the amount of tax which would have been imposed as a result of such acquisition if such acquisition had been subject to such tax.*

The proposed change is designed to provide consistent treatment in the bill on the exercise of rights to convert foreign debt obligations acquired by Americans from other Americans, and to facilitate trading in these securities among Americans.

Section 4912 (a) of the bill provides that the exercise of the right to convert a foreign debt obligation which is convertible for at least 5 years after interest begins to accrue is a taxable acquisition of stock by the person exercising the right. The revised subparagraph will permit a U.S. holder of such convertibles to offset against the tax liability arising on conversion any tax which would have been payable if the convertible obligations had been acquired in a transaction subject to the tax, regardless of whether such a tax was actually paid. The proposed change removes the distinction which would allow a credit to U.S. persons acquiring foreign convertibles directly from the foreign issuer in a private placement, but would deny the credit to a purchaser in a public offering, who acquires from the U.S. underwriter and not directly from the foreign issuer. The amendment will make the credit available to both.

(B) EXERCISE OF CERTAIN SHAREHOLDERS' RIGHTS. Page 9, line 12.

This subparagraph should be amended to read as follows:

> "The tax imposed upon an acquisition of stock or a debt obligation of a foreign corporation by a United States person [who is a shareholder of such corporation], where—
>
> "(i) the stock or debt obligation is acquired pursuant to the exercise of an option or similar right to acquire such stock or debt obligation which was acquired [by such person] *by a shareholder of such corporation* in a distribution [by such corporation] with respect to to its stock, and
>
> "(ii) such option or right [by its terms expires or terminates within a period not exceeding 90 days from the date so distributed to him] *is exercised within 90 days from the date of its distribution by such corporation*
>
> shall be limited to the amount of tax which would have been imposed by section 4911 if the price paid under such option or right were the actual value of the stock or debt obligation acquired.

The proposed changes are designed to extend the benefit of using the exercise price as the tax base to subsequent holders of subscription rights as well as shareholders, and to permit this limitation to be used where exercise occurs within 90 days of the distribution, regardless of any ambiguity in the terms of the offering which might make it unclear whether the rights offering actually terminated within 90 days of issuance.

The balance-of-payments outflow in the case of the exercise of subscription rights is no greater than the exercise price, whether the rights are exercised by the original recipient or a subsequent purchaser. The proposed extension of the use of exercise price as the tax base for subsequent purchasers is thus consistent with the purposes of the bill, and removes a possible impediment to the market in such rights.

"*(c) Acquisitions by Certain Domestic Corporations and Partnerships.* Following page 11, line 3.

This new subsection should provide as follows:

> "*If stock or a debt obligation of a foreign issuer or obligor is acquired by a domestic corporation or a domestic partnership with funds obtained as the result of an acquisition by a United States person of stock or a debt obligation of such corporation or partnership which under section 4912(b)(3) is deemed an acquisition by such person of stock or a debt obligation of a foreign issuer or obligor, the tax imposed upon the acquisition by the domestic corporation or the domestic partnership shall be limited to—*
>
> "*(1) the amount of tax imposed by section 4911, less*
>
> "*(2) the amount of tax paid by the United States person from whom the funds were obtained on the acquisition by such person which under section 4912(b)(3) is deemed an*

acquisition of stock or a debt obligation of a foreign issuer or obligor.

This proposed subsection is designed to prevent the imposition of a double tax on the same transaction, where a foreign borrower has made use of a domestic corporation or partnership as a conduit to acquire funds from a U.S. lender.

Under section 4912(b)(3) of the bill, the legal entities of domestic corporations and partnerships which are formed or availed of for the principal purpose of channeling funds to foreign borrowers are disregarded with respect to such transactions, and the U.S. lender is taxed as if he were acquiring the stock or debt obligation directly from the foreign issuer or obligor. The present bill could also be construed to require a second tax to be imposed when the domestic entity passes the same funds along to the foreign corporation or partnership in exchange for the latter's debt obligation (or stock). Such a double tax goes beyond the necessary scope of the bill, and the proposed amendment will eliminate the possibility of that result.

Section 4914. EXCLUSION FOR CERTAIN ACQUISITIONS

(b) EXCLUDED ACQUISITIONS. Page 12, line 18.

"(4) *Acquisitions in lieu of payment of foreign tax.* Following page 14, line 4.

This is a new paragraph of subsection (b); present paragraph (4) should be renumbered (6).

> *"Of stock or debt obligations by a United States person doing business in a foreign country, to the extent such acquisition is made, in conformity with the laws of such foreign country, as a substitute for the payment of tax to such foreign country.*

This new provision excludes from tax the acquisition of foreign securities if such securities are purchased in lieu of the payment by a United States person doing business in a foreign country of tax imposed by that country. Certain foreign countries permit taxpayers to acquire foreign securities, generally housing bonds, instead of paying certain taxes imposed by the country. This paragraph recognizes that such a purchase should not be subject to the interest equalization tax since such an acquisition is not made in response to any interest rate differential between the United States and the foreign country.

"(5) *Acquisitions of stock in cooperative housing corporations.* Following page 14, line 4.

This is a new paragraph (5) of subsection (b).

> *"Of stock of a foreign corporation which entitles the holder, solely by reason of his ownership of such stock, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation.*

This proposed exclusion is designed to permit a U.S. person to acquire stock in a foreign corporation for the purpose of obtaining the right to occupy a house, or an apartment in a building, owned or leased by the corporation. Under the bill as presently drafted such an acquisition would be subject to the tax unless the U.S. person acquired a 10 percent or more interest in the foreign corporation. On the other hand, the tax is not applicable to the rental of an apartment by an

American living abroad, or to the purchase of a house abroad. The proposed change provides equivalent treatment to stock in cooperative housing corporations. The acquisition of stock in a corporation for the purpose of obtaining a dwelling would normally not be motivated by an interest rate differential between the United States and foreign countries.

(c) EXPORT CREDIT, ETC., TRANSACTIONS. Page 15, line 1.

(1) IN GENERAL. Page 15, line 2.

This paragraph should be amended as follows:

> "The tax imposed by section 4911 shall not apply to the acquisition from a foreign obligor of a debt obligation arising out of the sale of tangible personal property or services (or both) to such obligor by any United States person, if—
>
> "(A) payment of such debt obligation (*or of any related debt obligation arising out of such sale*) is guaranteed or insured, in whole or in part, by an agency or wholly-owned instrumentality of the United States; or
>
> "(B) * * *.

This proposed change makes clear that if payment of part of a loan is guaranteed or insured by an agency or wholly owned instrumentality of the United States, such as the Export-Import Bank, that portion of the loan which is not guaranteed or insured is excluded from the tax. This is true even if separate debt obligations are given for the guaranteed and nonguaranteed portions of the loan. This exclusion is based on the fact that the Export-Import Bank guarantees or insures a portion of a loan only if the entire loan is attributable to the sale of goods produced in the United States.

(3) *Certain interests in intangible personal property.* Following page 16, line 20. This is a new paragraph. Present paragraph (3) should be renumbered (4).

This new paragraph should read as follows:

> *"The tax imposed by section 4911 shall not apply to the acquisition by a United States person from a foreign issuer or obligor of its stock in payment for, or of a debt obligation arising out of, the sale to such issuer or obligor of—*
>
> *"(A) any interest in patents, inventions, models or designs (whether or not patented), copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, or other like property (or any combination thereof), or*
>
> *"(B) any such interest together with services to be performed, in connection with any such interest sold, by such United States person (or by one or more includible corporations in an affiliated group, as defined in section 1504, of which such person is a member),*
>
> *if not less than 85 percent of the purchase price is attributable to the sale of any interest in property described in subparagraph (A) which was produced, created, or developed in the United States by such United States person (or by one or more such includible corporations), or is attrib-*

utable to the sale of any interest in such property so produced, created, or developed and to the performance of services described in subparagraph (B).

This new provision is designed to provide a U.S. person who is selling intangible property, such as know-how, patents, and copyrights, treatment consistent with that already accorded to exporters of tangible property. Frequently, the sale of intangible property involves the acquisition by the selling U.S. person of a 10-percent interest in the foreign purchaser, which would be excluded from tax as a direct investment. However, there are situations where a 10-percent interest may not be acquired, particularly where the seller is a small U.S. company selling to a large foreign corporation. This new provision would permit a U.S. seller of intangible property to receive stock or debt obligations in connection with the sale of property which he produced, created, or developed, or in connection with the furnishing of services related to the sale of such property.

"(5) OTHER LOANS RELATED TO SALES BY UNITED STATES PERSONS. Page 17, line 14.

This paragraph should be amended as follows:

"The tax imposed by section 4911 shall not apply to the acquisition from a foreign obligor by a United States person of a debt obligation of such obligor if such debt obligation—

"(A) was received by such United States person as all or part of the purchase price provided in a contract under which the foreign obligor agrees to purchase for a period of 3 years or more ores or minerals (or derivatives thereof)—

(*i*) extracted outside the United States [(i)] by such United States person [(ii)] *or* by one or more includible corporations in an affiliated group (as defined in section 48(c)(3)(C)) of which such United States person is a member,

(ii) extracted outside the United States by a corporation at least 10 percent of the total combined voting power of all classes of stock of which is owned, directly or indirectly, by such United States person, by one or more such includible corporations, or by domestic corporations which own, directly or indirectly, at least 50 percent of the total combined voting power of all classes of stock of such United States person, or

(iii) obtained under a contract entered into on or before July 18, 1963, by such United States person, by one or more such includible corporations, or by such domestic corporations; or

[(iii) by a corporation at least 10 percent of the total combined voting power of all classes of stock of which is owned by such United States person, if at least 50 percent of such voting power is owned by United States persons each of whom owns at least 10 percent of such voting power; or]

"(B) arises out of a loan (made by such United States person to such foreign obligor) the proceeds of which will be used by such obligor for the installation, maintenance, or improvement of facilities outside the United States which (during the period the loan is outstanding) will be used for the storage, handling, transportation, processing, or servicing of ores or minerals (or derivatives thereof) a substantial portion of which is extracted outside the United States by such United States person or by a corporation referred to in clause [(ii) or (iii)] *(i) or (ii)* of subparagraph (A) *or is obtained under a contract described in clause (iii) of subparagraph (A).*

This proposed change expands the exemption for ores and minerals extracted and sold outside the United States to include the sale of those ores and minerals in which the U.S. person has a substantial economic interest.

This change would permit an exclusion if the ores or minerals being sold by the U.S. person under a long-term sales contract are extracted outside the United States by the U.S. person acquiring the debt obligation, an affiliated company, or by a corporation in which the U.S. person, domestic corporations owning at least 50 percent of the voting stock of the U.S. person, or an affiliated company holds a direct investment (10 percent of the total voting stock), whether or not U.S. persons own 50 percent of the total voting stock of the foreign corporation. The proposed change also qualifies ores or minerals obtained under a contract entered into on or before July 18, 1963, by such U.S. person, domestic corporations, or an affiliated company, whether or not the extraction is performed by them. The bill also permits U.S. persons to acquire debt obligations of foreign obligors tax free if the proceeds of the loan are to be used by the borrower to install, maintain, or improve facilities for the storage, handling, transportation, processing, or servicing of ores or minerals extracted outside the United States which qualify under the proposed standards.

(e) ACQUISITIONS BY INSURANCE COMPANIES DOING BUSINESS IN FOREIGN COUNTRIES. Page 21, line 6.

(1) IN GENERAL. Page 21, line 8.

This paragraph should be amended as follows:

"The tax imposed by section 4911 shall not apply to the acquisition of stock or a debt obligation by a United States person which is an insurance company subject to taxation under section 802, 821, or 831, if [(A)] such stock or debt obligation is designated (in accordance with paragraph (3)) as part of a fund of assets established and maintained by such insurance company (in accordance with paragraph (2)) with respect to foreign risks insured or reinsured by such company under contracts (including annuity contracts) [which, by their terms, provide that the proceeds shall be payable] *the proceeds of which are payable* only in the currency of a foreign country[, and (B) the actual value of all of the assets held in such fund immediately after the stock or debt obligation has been designated as a part thereof does not exceed 110 percent

of the applicable allowable reserve determined in accordance with paragraph (4)]. As used in this subsection, the term "foreign risks" means risks in connection with property outside, or liability arising out of activity outside, or in connection with the lives or health of residents of countries other than, the United States.

The first change in the above provision is designed to make [clear that an insurance contract qualifies as a policy insuring a foreign risk if the company is obligated to make payment in a foreign currency, whether the obligation to make such payment is stated in the policy itself or is required under the law of the applicable foreign jurisdiction. The second change eliminates a provision the substance of which is found elsewhere in the subsection (pars. (3)(A)(i) and (3)(E)(i)).

(3) DESIGNATION OF ASSETS. Page 23, line 8.

(A) INITIAL DESIGNATION. Page 23, line 9.

This subparagraph should be amended as follows:

"(i) REQUIREMENT OF INITIAL DESIGNATION.—An insurance company desiring to establish a fund (or funds) of assets under paragraph (2) shall initially designate, as part or all of such fund (or funds), stock *and debt obligations owned by it on July 18, 1963, as follows: First, stock of foreign issuers, and debt obligations of foreign obligors having a period remaining to maturity (on July 18, 1963) of 3 years or more and payable in foreign currency; second, if the company so elects, debt obligations of foreign obligors having a period remaining to maturity (on July 18, 1963) of less than 3 years and payable in foreign currency; and third, debt obligations of foreign obligors having a period remaining to maturity (on July 18, 1963) of 3 years or more and payable solely in United States currency. The designation under the preceding sentence with respect to any fund shall be made, in the order set forth, to the extent that the adjusted basis (within the meaning of section 1011) of the designated stock and debt obligations was (on July 18, 1963) not in excess of 110 percent of the allowable reserve applicable to such fund (determined in accordance with paragraph (4)(B)(ii)), and shall in no case include any stock or debt obligation described in section 4916(a).* [of foreign issuers, or debt obligations of foreign obligors having a period remaining to maturity of 3 years or more, or both, which it owned on December 10, 1963, to the extent that such stock or debt obligations or both had an actual value as of such date not in excess (in the case of any such fund) of 110 percent of the applicable allowable reserve of such com-

pany as determined in accordance with paragraph (4)(A). The designation or designations which an insurance company is required to make shall be made first from stock and debt obligations which were acquired by such company on or before July 18, 1963, and shall in no case include any stock or debt obligations described in paragraph (1), (2), or (3) of section 4916(a).]

"(*ii*) TIME AND MANNER OF INITIAL DESIGNATION.—Any initial designation which an insurance company is required to make under this subparagraph shall be made on or before the 30th day after the date of the enactment of this chapter (or at such later time as the Secretary or his delegate may by regulations prescribe) by the segregation on the books of such company of the stock or debt obligations (or both) designated.

This revised subparagraph is designed to give insurance companies doing business in foreign countries a different method of establishing their funds of assets. Under the method presently provided in the bill, insurance companies cannot designate debt obligations as part of the fund as an initial designation unless the obligations were owned on both July 18 and December 10, 1963. This means that an obligation which was held on July 18, 1963, and which matured before December 10, 1963, could not be designated as part of the fund. Moreover, debt obligations with less than 3 years remaining to maturity cannot be initially designated. This prevents obligations of less than 3 years maturity payable in foreign currency from being the subject of an initial designation, despite the fact that they may be attributable to the foreign business carried on by the insurance company. These short-term obligations may have originally been purchased as long-term obligations or as short-term obligations with the intention by the insurance company of reinvestment in long-term obligations payable in foreign currency. If these short-term obligations payable in foreign currency cannot be designated as part of the fund before long-term obligations payable in U.S. currency, the insurance companies would be unable to replace tax free those short-term obligations which are attributable to their foreign operations.

The proposed subparagraph provides an alternative method of establishing the fund of assets. The order of designation is as follows: (1) Stock and long-term debt obligations payable in foreign currency; (2) at the election of the company, short-term obligations payable in foreign currency; and (3) long-term debt obligations payable in U.S. currency. Ownership on December 10, 1963, is not required, since inclusion of this date is not necessary for effective operation of this provision as amended.

This subparagraph also includes a change directed at the valuation of assets in the fund. Under the present provision in the bill, an insurance company would be required to ascertain the fair market value of its fund of assets, including appraisals of mortgages and private placements, at the time of each new acquisition of stock or debt obligations, to determine if the new acquisition could be designated as part

of the fund without exceeding the fund's 110-percent limit. In order to eliminate the necessity of frequent revaluations of the fund's assets and to simplify Government audit procedures, the proposed change permits valuation of the fund of assets in terms of the adjusted basis of the securities held. This is also the value used for purposes of determining gain on sale or other disposition of securities under the applicable provisions of the Internal Revenue Code relating to income tax treatment of insurance companies.

(*B*) CURRENT DESIGNATIONS TO MAINTAIN FUND. Page 24, line 17.

This subparagraph should be amended as follows:

> "To the extent permitted by subparagraph [(C)] *(E), stock of a foreign issuer or a debt obligation of a foreign obligor acquired by an insurance company after July 18, 1963, may be designated as part of a fund of assets described in paragraph (2), if such designation is made before the expiration of 30 days after the date of such acquisition and the company continues to own the stock or debt obligation until the time the designation is made*; [an insurance company may claim an exclusion under this subsection with respect to the acquisition of stock or a debt obligation of a foreign issuer or obligor after Decem-10, 1963, if such company designates such stock or debt obligation as part of a fund of assets described in paragraph (2) before the expiration of 30 days after the date of such acquisition (and continues to own it until the time the designation is made);] except that any such stock or debt obligation acquired before the initial designation of assets to the fund is actually made as provided in subparagraph (A)(ii) may be designated under this subparagraph at the time of such initial designation without regard to such 30-day period and continued ownership requirements.

The changes in this subparagraph are intended to conform the provision with the amendments proposed in subparagraph (A).

(*C*) *Additional designations after close of year.* Page 25, line 9.

This is a new subparagraph (C); present subparagraph (C) is deleted.

> *"If the adjusted basis of the assets held in a fund of assets described in paragraph (2) at the close of a calendar year after 1963 is less than 110 percent of the allowable reserve applicable to such fund at the close of such year, the insurance company may, to the extent permitted by subparagraph (E), designate additional stock or debt obligations (or both) which were acquired during such calendar year as a part of such fund, so long as the company still owns such stock or debt obligations at the time of designation. Any designation under this subparagraph shall be made on or before January 31 following the close of the calendar year.*

Any tax paid by such company under section 4911 on the acquisition of the additional stock or debt obligations so designated shall constitute an overpayment of tax; and, under regulations prescribed by the Secretary or his delegate, credit or refund (without interest) shall be allowed or made with respect to such overpayment.

This new subparagraph embodies the procedure now contained in paragraph (4)(B) of this subsection. This procedure permits an insurance company to designate stock and debt obligations as part of a fund of assets if the securities were acquired during the calendar year (and are held at the end of the year) and if the adjusted basis of the assets in the fund at the end of the year is less than 110 percent of the allowable reserve applicable to the fund. The securities may be designated up to the 110-percent limit. A credit or refund is available as to any tax which was paid on stocks or debt obligations which are so designated.

(D) Supplemental required designations.

This is a new subparagraph (D) following new subparagraph (C) added following line 8 on page 25.

If during any calendar year an insurance company acquires stock or debt obligations which are excluded from the tax imposed by section 4911 under an Executive order described in section 4917, and if at the close of the calendar year (and after the designation of additional assets under subparagraph (C)) the adjusted basis of all assets in a fund described in paragraph (2) is less than 110 percent of the allowable reserve applicable to such fund, such company shall, to the extent permitted by subparagraph (E), designate as part of such fund stock and debt obligations acquired by it during the calendar year and owned by it at the close of the calendar year, as follows: First, stock, and debt obligations having a period remaining to maturity (on the date of acquisition) of 3 years or more and payable in foreign currency, which were excluded from the tax imposed by section 4911 under such Executive order; second, if the company so elects, debt obligations of foreign obligors having a period remaining to maturity (on the date of acquisition) of less than 3 years and payable in foreign currency; and third, debt obligations having a period remaining to maturity (on the date of acquisition) of 3 years or more and payable solely in United States currency, which were excluded from the tax imposed by section 4911 under such Executive order. The designations under this subparagraph shall be made on or before January 31 following the close of the calendar year.

This new subparagraph establishes an ordering process for designating securities at the close of a calendar year if the fund of assets is not up to its 110-percent limit. The purpose of this provision is to prevent creation of a gap in the fund of assets which could defeat the

purposes underlying the imposition of a limit on the proposed exclusion for new issues provided in section 4917, if it were found necessary to impose such a limit. This gap could develop while the new issue exclusion was unlimited, if the insurance companies were not required to designate as part of the fund those securities which were excluded from tax under this new issue exclusion. If the President at a later time found it necessary to impose a limitation on this exclusion, insurance companies would then have room in their funds of assets to continue to buy new issues at a substantial rate. The proposed change prevents this result by requiring the designation at the end of the calendar year (if the fund is not full) of stock and long-term debt obligations (payable in foreign currency) which were originally excluded from tax during the calendar year under the new issue exemption; short-term debt obligations (payable in foreign currency), at the election of the company; and long-term debt obligations (payable in U.S. currency) which were originally excluded from tax during the calendar year under the new issue exemption.

(*E*) *Limitations.* Following new subparagraphs (C) and (D) added following line 8 on page 25.

This is a new subparagraph (E).

"(*i*) *In general.—No designation of stock or a debt obligation as a part of a fund of assets described in paragraph (2) shall be made under subparagraph (B), (C), or (D), to the extent that, immediately thereafter, the adjusted basis of all the assets held in such fund would exceed 110 percent of the applicable allowable reserve (determined in accordance with paragraph (4)(B)(i)).*

"(*ii*) *Treatment of excess designations.—To the extent that the adjusted basis of any stock or debt obligation designated as a part of a fund under subparagraph (B) during any calendar year, when added to the adjusted basis of all other assets held in such fund at the close of such calendar year, exceeds 110 percent of the allowable reserve applicable to such fund for such calendar year, the designation of such stock or debt obligation shall, for purposes of this subsection, be treated as ineffective, and the provisions of this chapter shall apply with respect to the acquisition of such stock or debt obligation as if such designation had not been made.*

"(*iii*) *Short-term obligations.—No designation may be made under subparagraph (B) or (C) of any debt obligation which has a period remaining to maturity (on the date acquired) of less than 3 years.*

Clause (i) of this subparagraph states the general principle that no designation of stock or debt obligations may be made if the designation causes the adjusted basis of the assets in the fund to exceed 110 percent of the allowable reserve applicable to the fund. A comparable provision now appears in the bill as (3)(C).

Clause (ii) of this subparagraph permits an insurance company to estimate the increase in its allowable reserve during a particular

calendar year. As the bill is presently drafted, an insurance company whose fund of assets is completely filled must pay the tax on acquisitions even though its foreign business may increase during the calendar year so as to permit designation of the securities at the end of the year. Under present procedure, the company is required to pay the tax, and at the end of the year, apply for a credit or refund based upon the actual increase in its reserve. The proposed change permits a company to designate securities as part of a fund of assets based upon its estimate of the allowable reserve applicable to the fund at the end of the year. If the adjusted basis of the stock or debt obligations designated as part of the fund during the year, together with all other assets held in the fund at the end of the year, is less than 110 percent of the allowable reserve applicable to the fund, no tax is due. If, however, the adjusted basis of these assets exceeds 110 percent, designations in excess of that figure are treated as ineffective, and the company must pay the tax plus any interest which may be due on the acquisitions which were the subject of ineffective designations.

Clause (iii) of this subparagraph is designed to prohibit maintenance designations of short-term obligations during the calendar year. The acquisition of these obligations is not subject to the tax, and such maintenance designations could be utilized by insurance companies as a method of avoiding the impact of a limitation which might be placed on the exclusion provided in section 4917 for issues orginating in a country where application of the tax to that country imperils or threatens to imperil the stability of the international monetary system (new issue exclusion). In anticipation of the establishment of such a limit, insurance companies could fill their funds with short-term obligations and, after a limit were imposed, replace them with new long-term obligations tax free. This would have the effect of frustrating the purposes of the limit. Under proposed subparagraph (D), at the close of the calendar year, short-term obligations may be designated *after* new long-term obligations payable in foreign currency which were excluded from tax under section 4917.

(4) DETERMINATION OF RESERVES. Page 25, line 16.

This paragraph should be amended as follows:

> "(A) GENERAL RULE.—For purposes of this subsection, the term 'allowable reserve' means—
>
> "(i) in the case of a life insurance company (as defined in section 801(a)), the items taken into account under section 810(c) arising out of contracts of insurance and reinsurance (including annuity contracts) which relate to foreign risks and the proceeds of which are payable in a single foreign currency (other than the currency of a less developed country); and
>
> "(ii) in the case of an insurance company other than a life insurance company (as so defined), the amount of its unearned premiums (*under section 832(b)(4)*) and unpaid losses (*under section 832(b)(5)*) which relate to foreign risks insured or reinsured under contracts providing for payment in foreign currencies (other than currencies of less developed countries)

and which are taken into account in computing taxable income under section 832[(b)(4) and (5)] (for such purpose treating underwriting income of an insurance company subject to taxation under section 821 as taxable income under section 832).

[The determination of an allowable reserve of an insurance company for any calendar year shall be made as of the close of the previous calendar year.]

"(*B*) *Time of determination.*—

"(*i*) *In general.—For purposes of paragraph (3) (other than subparagraph (A) of such paragraph), the determination of an allowable reserve for any calendar year shall be made as of the close of such year.*

"(*ii*) *Initial designation.—For purposes of paragraph (3)(A), the determination of an allowable reserve shall be made as of July 18, 1963. If the insurance company so elects, the determination under this clause may be made by computing the mean of the allowable reserve at the beginning and at the close of the calendar year 1963.*

Present subparagraph (B) is deleted.

The changes proposed in subparagraphs (A) and (B)(i) of this paragraph make clear that the determination of an allowable reserve for a fund of assets for any calendar year shall be made at the end of that year. Under the present bill, the reserve as of the close of the previous calendar year is used, although the company may elect to use the figure as of the close of the current year. This change recognizes that the reserve figure which should govern is the figure at the end of the current calendar year, which would reflect any increase in business during the year.

The amendment suggested in (B)(ii) of this paragraph establishes a new method for determining allowable reserve for the year 1963. Under this proposal, the determination of allowable reserve shall be made as of July 18, 1963 (the date on which securities which are initially designated must be owned). In the alternative, a company may compute the mean of its reserve at the beginning and the close of 1963. This figure, which can be readily ascertained, approximates the actual reserve figure on July 18, 1963. (The substance of present par. (4)(B) is now embodied in par. (3)(C).)

(g) *Sale or liquidation of wholly owned foreign subsidiary.* Page 28, line 23.

This is a new subsection (g). A revised subsection (g) appears below as subsection (i).

"(*1*) *In general.—The tax imposed by section 4911 shall not apply to the acquisition by a United States person of a debt obligation of a foreign obligor if the debt obligation is acquired—*

"(*A*) *in connection with the sale by such United States person (or by one or more includible corporations in an affiliated group, as defined in section 48(c)(3)(C), of which such United States person is a*

member) of all of the outstanding stock, except for qualifying shares, of a foreign corporation; or

"(B) in connection with the liquidation by such United States person (or by one or more such includible corporations) of a foreign corporation all of the outstanding stock of which, except for qualifying shares, is owned by such United States person (or by one or more such includible corporations); but only if such debt obligation had been received by such foreign corporation as part or all of the purchase price in a sale of substantially all of its assets.

"(2) LIMITATION.—Paragraph (1) shall not apply to the acquisition of a debt obligation if any of the stock sold or surrendered in connection with its acquisition was originally acquired with the intent to sell or surrender.

This new provision is designed to exclude from application of the tax bona fide sales of wholly owned subsidiaries, where the transaction is motivated by factors other than the interest rate differential between American and foreign security markets. Debt obligations acquired by a U.S. person in connection with such a sale would be excluded from tax, regardless of whether the transaction involves a sale of stock or a sale of assets. The particular form of the sale is usually determined by the purchaser of the business involved, but the effect on the U.S. person will be the same in either situation. In the case of a sale of stock, the U.S. parent will acquire the debt obligations directly from the issuer. In the case of a sale of assets, the U.S. person will acquire the debt obligation upon the liquidation of its subsidiary, in exchange for the latter's stock. The proposal requires that the sale or surrender of stock involve all of the outstanding stock of a foreign corporation (except qualifying shares) and excludes the acquisition from tax unless the stock of the foreign corporation was originally acquired with the intent to sell or surrender.

(*h*) *CERTAIN DEBT OBLIGATIONS SECURED BY UNITED STATES MORTGAGES, ETC.* Following page 31, line 25.

This is a new subsection (h) of section 4914.

"(1) IN GENERAL.—The tax imposed by section 4911 shall not apply to the acquisition from a foreign obligor by a United States person of a debt obligation of such foreign obligor which is secured by real property located in the United States, to the extent—

"(A) the debt obligation is a part of the purchase price of such real property (or of such real property and related personal property), or

"(B) the debt obligation arises out of a loan made by such United States person to the foreign obligor the proceeds of which are concurrently used as part of the purchase price of such real property (or of such real property and related personal property).

"(2) LIMITATION.—Paragraph (1) shall apply to the acquisition of a debt obligation only if—

"(A) the owner of the property sold is a United States person, and

"(B) at least 25 percent of the purchase price of the property sold is, at the time of such sale, paid in United States currency to such United States person by the foreign obligor from funds not obtained from United States persons for the purpose of purchasing such property.

"(3) RELATED PERSONAL PROPERTY.—For purposes of paragraph (1), the term 'related personal property' means tangible personal property which is sold in connection with the sale of real property for use in the operation of such real property.

This provision is designed to prevent application of the tax in the case of a loan secured by real property located in the United States to finance the purchase of such real property by a foreigner involving a large cash downpayment (at least 25 percent of the sales price) to the U.S. seller. A transaction of this type has a favorable effect on our balance of payments, and would not have occurred if the financing were not available. Since the obligation is secured by U.S. real estate, there is no risk that the property involved will not remain in the United States, as would be the case with respect to personal property.

(i) *LOSS OF ENTITLEMENT TO EXCLUSION IN CASE OF CERTAIN SUBSEQUENT TRANSFERS.* Following new subsection (L) added following line 25 on page 31.

This is a revised subsection (g).

"(1) IN GENERAL.—

"(A) Where an exclusion provided by paragraph (1)(B), (2), (3), [or] (4), *or (5)* of subsection (c), or the exclusion provided by subsection (d), has applied with respect to the acquisition of a debt obligation by any person, but such debt obligation is subsequently transferred by such person (before the termination date specified in section 4911(d)) to a United States person otherwise than—

"(i) to any agency or wholly-owned instrumentality of the United States;

"(ii) to a commercial bank acquiring the obligation in the ordinary course of its commercial banking business; [or]

"(iii) in the case of an exclusion provided by paragraph (1)(B), (2), or (3) of subsection (c), to any transferee where the extension of credit by such person and the acquisition of the debt obligation related thereto were reasonably necessary to accomplish the sale of property or services out of which the debt obligation arose, and the terms of the debt obligation are not unreasonable in light of credit practices in the business in which such person is engaged; or

"[(iii)] *(iv)* in a transaction described in subsection (a)(1) or (2), or a transaction (other than a transfer by gift) described in subsection (a)(3),

then liability for the tax imposed by section 4911 (in an amount determined under subparagraph (D) of this paragraph) shall be incurred by the transferor (with respect to such debt obligation) at the time of such subsequent transfer.

"(B) Where the exclusion provided by paragraphs (2) *and (3)* of subsection (c) has applied with respect to the acquisition of stock by any person, but such stock is subsequently transferred by such person (before the termination date specified in section 4911(d)) to a United States person otherwise than in a transaction described in subsection (a)(1) or (2), or a transaction (other than a transfer by gift) described in subsection (a)(3), then liability for the tax imposed by section 4911 (in an amount determined under subparagraph (D) of this paragraph) shall be incurred by the transferor (with respect to such stock) at the time of such subsequent transfer.

The proposed change in subparagraph (A) liberalizes the provisions applicable to the transferability of debt obligations received by an exporter so as not to interfere with the legitimate export financing of U.S. companies. The bill now provides that export paper may be transferred only to an agency or wholly-owned instrumentality of the United States, a commercial bank in the ordinary course of its commercial banking business, or by operation of law. This proposal permits transfer to other U.S. persons, provided the original extension of credit by the exporter was reasonably necessary to accomplish the export, and the terms of the debt obligation are not unreasonable in light of credit practices in the exporter's business.

The proposed change in subparagraph (B) applies the restrictions applicable to the transfer of stock received in connection with the export financing of tangible personal property to intangible personal property, in accordance with new section 4914(c)(3).

Section 4915. EXCLUSION FOR DIRECT INVESTMENTS

(a) IN GENERAL. Page 32, line 2.

(1) EXCLUDED ACQUISITIONS. Page 32, line 3.

This paragraph should be amended to read as follows:

"Except as provided in subsections (c) and (d) of this section, the tax imposed by section 4911 shall not apply to the acquisition by a United States person (A) of stock or a debt obligation of a foreign corporation *or of a debt obligation from a foreign corporation which received such obligation in the ordinary course of its trade or business as a result of the sale or rental of products manufactured or assembled by it or of the performance of services by it,* if immediately after the acquisition such person (or one or more includible corporations in an affiliated group, as defined in section 1504, of which such person is a member) owns (directly or indirectly) 10 percent or more of the total combined voting power of all classes of stock of such foreign corporation, or (B) of stock or a debt obligation of a foreign partnership if immediately after the acqui-

sition such person owns (directly or indirectly) 10 percent or more of the profits interest in such foreign partnership. * * *

This proposed change extends the direct investment exclusion to the acquisition by a U.S. corporation of installment receivables acquired by its subsidiary in connection with the sale or rental of products manufactured or assembled by the subsidiary or the performance of services by the subsidiary.

Under the bill as presently drafted a U.S. corporation can lend funds to a foreign subsidiary and acquire a debt obligation in return tax free. In certain instances, the U.S. corporation may be restricted by trust indentures or other agreements in its ability to lend to a subsidiary. If this is the case, the U.S. corporation may be permitted under the trust indenture to finance its subsidiaries by acquiring the installment receivables received by the subsidiaries in the ordinary course of conducting their business. The proposed amendment recognizes this practice as an alternative to a direct investment and excludes acquisition of the receivables from the tax.

(2) OVERPAYMENT WITH RESPECT TO CERTAIN TAXABLE ACQUISITIONS. Page 32, line 23.

This paragraph should be amended to read as follows:

> "The tax paid under section 4911 on the acquisition *by a United States person* of stock *or a debt obligation* of a foreign corporation or foreign partnership, *or a debt obligation from a foreign corporation which received such obligation in the ordinary course of its trade or business as a result of the sale or rental of products manufactured or assembled by it or of the performance of services by it,* [by a United States person] shall (unless this subsection is inapplicable by reason of subsection (c) or (d)) constitute an overpayment of tax if such person — [continuously holds such stock from the time of its acquisition to the last day of the calendar year in which the acquisition was made and as of such last day meets the ownership requirement of paragraph (1).]
>
> "*(A) meets the ownership requirement of paragraph (1) with respect to such corporation or partnership at any time within 12 months after the date of such acquisition, and*
>
> "*(B) holds the stock or debt obligation continuously from the date of such acqusition to the last day of the calendar year in which such ownership requirement is first met.*
>
> Under regulations prescribed by the Secretary or his delegate, credit or refund (without interest) shall be allowed or made with respect to such overpayment.

This provision and proposed change are designed to avoid hardship in a case where a U.S. person is unable to satisfy in a single acquisition the 10 percent or more voting stock requirement of the direct investment provisions, but where he acquires the requisite 10-percent interest over a 12-month period. It also extends the credit or refund provisions to the acquisition of debt obligations under these circumstances.

The bill now provides an exclusion for acquisitions if a U.S. person

acquires stock in a foreign corporation or partnership in a series of transactions, if at the end of the calendar year involved the person holds a 10-percent or greater stock interest. The proposed change makes clear that the exclusion is available if the 10-percent interest is acquired in any 12-month period, whether or not the 12-month period coincides with a particular calendar year, and allows the credit or refund in the case of debt obligations acquired in such situations.

Section 4916. EXCLUSION FOR INVESTMENTS IN LESS DEVELOPED COUTRIES

(a) GENERAL RULE. Page 37, line 14.

Subsection (a) should be amended as follows:

> "The tax imposed by section 4911 shall not apply to the acquisition by a United States person of—
>
> "(1) a debt obligation issued or guaranteed by the government of a less developed country or a political subdivision thereof, or by an agency or instrumentality of such a government;
>
> "(2) stock or a debt obligation of a less developed country corporation; [or]
>
> "(3) a debt obligation issued by an individual or partnership resident in a less developed country in return for property which is used, consumed, or disposed of wholly within one or more less developed countries[.]*; or*
>
> *"(4) stock or a debt obligation of a foreign issuer or foreign obligor, to the extent that such acquisition is required as a reinvestment within a less developed country by the terms of a contract of sale to, or of a contract of indemnification with respect to the nationalization, expropriation, or seizure by, the government of such less developed country or a political subdivision thereof, or an agency or instrumentality of such government, of property owned within such less developed country or such political subdivision by such United States person, or by a controlled foreign corporation (as defined in section 957) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of which is owned (within the meaning of section 958) by such United States person, but only if such contract was entered into because the government of such less developed country or political subdivision, or such agency or instrumentality—*
>
> *"(A) has nationalized or has expropriated or seized, or has threatened to nationalize or to expropriate or seize, a substantial portion of the property owned within such less developed country or such political subdivision by such United States person or such controlled foreign corporation; or*
>
> *"(B) has taken action which has the effect of nationalizing or of expropriating or seizing, or of threatening to nationalize or to expropriate or seize, a substantial portion of the property so owned.*

New paragraph (4) is designed to exclude from the proposed tax the acquisition of securities of a company operating in a less developed country with the proceeds from the payment by the government of

that country or its instrumentality for the stock or assets of a business previously operated in that country by the U.S. person. The U.S. person must prove the payment for his property is an indemnification for the seizure of property or compelled under threat of expropriation. The U.S. person seeking an exclusion under this provision must also show that the reinvestment of the sales proceeds within the less developed country was required by the contract terms.

In the circumstances contemplated by the proposed amendment, the companies in which the U.S. person must reinvest presumably would qualify as less developed country corporations under the requirements of section 4916(c)(1), particularly in light of the interests of the less developed country. However, the officers of these companies are aware of the pressures on the U.S. person seeking reinvestment in these circumstances, and they are under no compulsion to reveal information regarding their assets and income which is required to establish less developed country corporation status. Such information is not otherwise available. Moreover, the contract generally requires reinvestment within a specified period of time, which increases the pressure on the U.S. person.

(c) LESS DEVELOPED COUNTRY CORPORATION DEFINED. Page 40, line 3.

(1) IN GENERAL. Page 40, line 5.

Paragraph (1) should be amended to read as follows and a new paragraph (2) should be added. Present paragraph (2) should be renumbered (3).

"For purposes of this section, the term 'less developed country corporation' means a foreign corporation which for the applicable periods set forth in paragraph [(2)] *(3)*—

"(A) meets the requirements of section 955(c) (1) or (2); or

"(B) [has gross income 80 percent or more of which is derived] *derives 80 percent or more of its gross income, if any,* from sources within less developed countries, *or from deposits in the United States with persons carrying on the banking business, or both,* and has assets 80 percent or more in value of which consists of—

"(*i*) property described in clauses (*ii*), (iii), (iv), and (v) of section 955(c)(1)(B),

"(*ii*) *property described in section 956(b)(1) (regardless of when acquired),*

"(*iii*) *debt obligations described in paragraph (3) of subsection (a) of this section, and*

"(*iv*) *obligations of the United States;*

except that in applying this paragraph the determination of whether a foreign country is a less developed country shall be made in accordance with subsection (b) of this section.

"(*2*) *SPECIAL RULES.—For purposes of subparagraphs (A) and (B) of paragraph (1)—*

"(*A*) *income derived from property described in section 956(b)(1) (regardless of when acquired) shall not be taken into account, and*

> "*(B) obligations of any other less developed country corporation shall be taken into account under section 955(c)(1)(B)(iii) without regard to the period remaining to maturity at the time of their acquisition.*
>
> *For purposes of subparagraph (B) of paragraph (1) deposits outside the United States (other than deposits in a less developed country) with persons carrying on the banking business, and income from such deposits, shall not be taken into account.*

The proposed changes in this subsection are designed to prevent disqualification of less developed country corporations from the exclusion from tax intended under this section because of investments in U.S. property or income derived from U.S. sources, or because of the fact that some of the corporation's assets consist of debt obligations of less developed country corporations which have a short-term maturity, or debt obligations of individuals or partnerships resident in less developed countries.

The criteria established in the present bill for determining less developed country corporation status were derived primarily from income tax concepts established in the Revenue Act of 1962. These criteria have been expanded in the manner described to accommodate them to the purposes of the interest equalization tax.

Section 4917. EXCLUSION FOR ORIGINAL OR NEW ISSUES WHERE REQUIRED FOR INTERNATIONAL MONETARY STABILITY

(b) APPLICABILITY OF EXECUTIVE ORDER. Page 35, line 13.

This subsection should be amended to read as follows:

> "An Executive order described in subsection (a) may be applicable to all such original or new issues or to any aggregate amount or classification thereof which shall be stated in such order and shall apply to acquisitions occurring during such period of time as shall be stated therein. If the order is applicable to a limited aggregate amount of such issues it shall apply (under regulations prescribed by the Secretary or his delegate) to those acquisitions as to which notice of acquisition was first filed, provided that in the case of any such notice the acquisition described in the notice is made before or within 90 days after the date of filing *or such longer period after such date as may be specified in such order.*

This change is necessary so that in the event the President deems it advisable to impose a limitation on the exclusion for original or new issues originating in a particular country the procedural requirements for administering such a limitation would be sufficiently flexible. If a limitation is imposed, it may be deemed appropriate to permit a longer period of time between the date of filing notice and the date of acquisition as to certain types of acquisitions where a 90-day limit is not feasible.

(c) ORIGINAL OR NEW ISSUE. Page 45, line 25.

This subsection should be amended to read as follows:

> "For purposes of this section—
>
> "(*1*) stock shall be treated as part of an original or new issue only when it is acquired from the issuer by the United States person claiming the exclusion; and

"(2) a debt obligation shall be treated as part of an original or new issue only if acquired not later than [60] *90* days after the date on which interest begins to accrue on such obligation, *except that a debt obligation secured by a lien on improvements on real property which are under construction or are to be constructed at the time such obligation is issued (or if such obligation is one of a series, at the time the first obligation in such series is issued) shall be treated as part of an original or new issue if—*

"(A) such obligation is acquired not later than 90 days after the date on which interest begins to accrue on the total amount of such obligation (or if such obligation is one of a series, on the last issued of the obligations in such series); and

"(B) the United States person claiming the exclusion became committed to the acquisition of such obligation not later than 90 days after the date on which interest began to accrue on any part of such obligation (or, if such obligation is one of a series, on the first obligation issued in such series).

The proposed change as to the definition of a new issue where a construction loan is involved is necessary so that such loans are eligible to qualify under this exclusion. Typically, the U.S. person may not acquire the debt obligation involved until construction has been completed and several months have elapsed since interest began to accrue on the obligation. Accordingly, the proposed change would commence the 90-day period after interest began to accrue on the total obligation (or if a series of obligations is involved, the last-issued obligation in the series), provided the U.S. person was committed to acquire the obligation within 90 days after interest began to accrue on any part of the obligation (or if a series of obligations is involved, the first issued).

Section 4918. EXEMPTION FOR PRIOR AMERICAN OWNERSHIP

(a) General rule. Page 46, line 9.
This subsection should be amended as follows:

"The tax imposed by section 4911 shall not apply to an acquisition of stock or a debt obligation of a foreign issuer or obligor if it is established *in the manner provided in this section* [by clear and convincing evidence] that the person from whom such stock or debt obligation was acquired was a United States person throughout the period of his ownership or continuously since July 18, 1963 *and was a United States person eligible to execute a certificate of American ownership with respect to such acquisition.*

This change, together with the amendment proposed in subsection (f) below, is intended to make clear that in cases where a confirmation received from a member of a national securities exchange or the National Association of Securities Dealers does not serve as proof of prior American ownership, a purchaser claiming an exemption based on prior American ownership must produce a certificate of American ownership to substantiate his claim, unless the failure to produce a certificate is due to reasonable cause. In the overwhelming majority

of acquisitions through American broker-dealers, a confirmation will serve as proof of prior American ownership. In those cases where a confirmation is not received, a certificate of American ownership must be obtained in order to establish the exemption. It is proposed that this certificate requirement be made mandatory in order to forestall possible evasion of the tax by Americans who purchase from other Americans who are being treated as foreigners for a particular purpose under the bill. For example, a U.S. person purchasing from a dealer who claims a credit or refund under section 4919 should not be permitted to assert the exemption for prior American ownership since the dealer can not execute the requisite certificate in connection with the transaction.

(c) TRADING ON CERTAIN NATIONAL SECURITIES EXCHANGES. Page 46, line 23.

This subsection should be amended to read as follows:

> "For purposes of subsection (a), a written confirmation, received from a member or member organization of a national securities exchange registered with the Securities and Exchange Commission [stating that an acquisition was made in the regular market on such exchange (and not subject to a special contract)] *in connection with an acquisition on such exchange, which does not state that such acquisition was made subject to a special contract* shall be conclusive proof for purposes of this exemption of prior American ownership * * *

The proposed change conforms the language of the bill to the rules adopted by national securities exchanges in connection with the trading of foreign securities subject to the tax. Under exchange rules, a purchaser in the regular market on the exchange is assured that he is acquiring from another American and, accordingly, is not liable for the tax or required to file a return. The purchaser's confirmation, which does not contain a statement that his acquisition is subject to the tax, is considered conclusive proof of prior American ownership.

(f) *OTHER PROOF OF EXEMPTION*. Following page 50, line 5.

This is a new subsection.

> *"For purposes of subsection (a), if a person establishes, with respect to an acquisition, that there is reasonable cause for his inability to establish prior American ownership under subsection (b), (c) or (d), he may establish prior American ownership for purposes of this exemption by other evidence that the person from whom such acquisition was made was a United States person eligible to execute a certificate of American ownership with respect to such acquisition.*

This suggested amendment is proposed for the reasons set forth above under subsection (a).

Section 4919. SALES BY UNDERWRITERS AND DEALERS TO FOREIGN PERSONS

(a) CREDIT OR REFUND. Page 50, line 8.

(1) PRIVATE PLACEMENTS and (2) PUBLIC OFFERINGS. Page 50, line 12, and page 50, line 19.

These two paragraphs should be deleted and a new consolidated paragraph should be substituted to read as follows:

"(*1*) *PRIVATE PLACEMENTS AND PUBLIC OFFERINGS.—Are acquired by an underwriter in connection with a private placement or a public offering by a foreign issuer or obligor (or a person or persons, directly or indirectly, controlling, controlled by, or under common control with such issuer or obligor) and are sold as part of such private placement or public offering by the underwriter (including sales by other underwriters who are United States persons participating in the placement or distribution of the stock or debt obligations acquired by the underwriter) to persons other than United States persons;*

This proposed revision will equalize the treatment of foreign underwritings, whether in the form of a public offering or private placement, and prevent the loss of the credit or refund for resales to foreigners because of distribution practices prevailing in a particular foreign country.

The bill presently requires that the underwriter in a private placement sell directly to foreigners to qualify for the credit or refund while in the case of public offerings, the sales to foreigners may be made by selling group members. In some foreign countries, the concept of "private placement" includes offerings where selling groups are utilized. The proposed change will eliminate the distinction between the treatment of private placements and public offerings and will allow the credit or refund in all underwriting situations where the foreign stock or debt obligations are placed with foreign investors, and U.S. persons are only part of the distribution and placement process.

(*2*) *Certain debt obligations.* Page 51, line 4.

This paragraph which was formerly (3) should be amended to read as follows:

"Consist of debt obligations—

"(*A*) acquired by a dealer in the ordinary course of his business and sold by [the dealer to persons other than United States persons within 90 days after (or, in the case of short sales, within 90 days before) their acquisition] *him, within 90 days after their purchase, to—*

"(*i*) *persons other than United States persons, or*

"(*ii*) *another dealer who resells them on the same or the next business day to persons other than United States persons; or*

"(*B*) *acquired by a dealer in the ordinary course of his business to cover short sales made by him, within 90 days before their purchase, to—*

"(*i*) *persons other than United States persons, or*

"(*ii*) *another dealer who resold them on the same or the next business day to persons other than United States persons.*

This proposed change will insure that the credit or refund available to dealers in case of the sale of foreign bonds to foreigners within 90 days after acquisition is not lost because of the form of the transaction.

This provision now requires that in order to qualify for the credit or refund the dealer must sell to a foreign person within 90 days after acquisition. However, a substantial percentage of the transactions of this type involve a sale by the U.S. dealer to another U.S. dealer who in turn sells to a foreigner. The second U.S. dealer normally does not buy unless he has a foreign customer prepared to purchase from him. The proposed change recognizes this practice and permits the credit or refund, provided the second dealer sells to a foreigner on the same day as he purchases from the first dealer or the next business day.

(3) *Certain stock.* Page 51, line 4.

This is a new paragraph (3).

> "*Consist of stock acquired by a dealer in the ordinary course of his business and sold by him, on the same business day on which they were purchased, to persons other than United States persons.*
>
> Under regulations prescribed by the Secretary or his delegate, credit or refund (without interest) shall be allowed or made with respect to such overpayment. *For purposes of paragraphs (2) and (3) of this subsection and for purposes of paragraph (3) of subsection (b), the day of purchase or sale of any stock or debt obligation is the day on which an order to purchase or to sell, as the case may be, is executed.*

This new paragraph is designed to permit dealers in securities to be able to conduct certain types of arbitrage transactions in stocks without at the same time weakening the effectiveness of the tax. The last sentence of the provision makes clear that the purchase or sale date is the day on which the buy or sell order is executed, for purposes of this provision and the bond provision of (2) above.

The present bill does not contain a provision allowing a credit or refund where dealers acquire foreign stocks and sell to foreigners. This has had the effect of limiting certain types of arbitrage activities on exchanges. To alleviate this problem, the proposed change allows a credit or refund where a dealer sells foreign stock to a foreign person on the same day the stock is purchased. This proposal does not contain a 90-day provision as in the case of bonds because of the possibility that a broad dealer exclusion in stocks could become a tax-free vehicle for speculation in foreign securities.

(b) EVIDENCE TO SUPPORT CREDIT OR REFUND. Page 51, line 13.

The contents of present subsection (b) are incorporated in paragraphs (1) and (2) of new subsection (b). Paragraph (3) is entirely new.

> "*(1) IN GENERAL.—Credit or refund shall be allowed to an underwriter or dealer under subsection (a) with respect to any stock or debt obligation sold by him only if the underwriter or dealer—*
>
> "*(A) files with the return required by section 6011 (d) on which credit is claimed, or with the claim for*

refund, such information as the Secretary or his delegate may prescribe by regulations, and

"(*B*) *establishes that such stock or debt obligation was sold to a person other than a United States person.*

In any case where two or more underwriters form a group for the purpose of purchasing and distributing (through resale) stock or debt obligations of a single foreign issuer or obligor, any one of such underwriters may, to the extent provided by regulations prescribed by the Secretary or his delegate, satisfy the requirements of this paragraph on behalf of all such underwriters.

"(*2*) *CERTAIN SALES BY UNDERWRITERS.—For purposes of paragraph (1)(B), in the case of a claim for credit or refund under subsection (a)(1) with respect to stock or a debt obligation acquired by an underwriter and not sold by him directly to a person other than a United States person, a certificate of sale to a foreign person (setting forth such information, and filed in such manner, as the Secretary or his delegate may prescribe by regulations), executed by the underwriter who made such sale, shall be conclusive proof that such stock or debt obligation was sold to a person other than a United States person, unless the underwriter relying upon the certificate has actual knowledge that the certificate is false in any material respect.*

"(*3*) *SALES BY DEALERS.—*

"(*A*) *SALES ON NATIONAL SECURITIES EXCHANGES.—For purposes of paragraph (1)(B), in the case of a claim for credit or refund under subsection (a)(2), the sale by a dealer of a debt obligation on a national securities exchange registered with the Securities and Exchange Commission subject to a special contract (and not in the regular market) shall be conclusive proof that such debt obligation was sold to a person other than a United States person, if such exchange has in effect at the time of the sale rules providing that—*

"(*i*) *a member or member organization of such exchange selling a debt obligation as a dealer, or effecting the sale as broker of a debt obligation on behalf of a dealer, on such exchange subject to a special contract (and not in the regular market) shall furnish to the member or member organization purchasing such debt obligation as a dealer, or effecting the purchase as broker of such debt obligation on behalf of a dealer, a written confirmation or comparison stating that such sale is being made as a dealer, or on behalf of a dealer; and*

"(*ii*) *if the purchaser of such debt obligation is a dealer (whether or not a member or member organization of such exchange), the terms of the contract applicable to such sale shall require the purchasing dealer to undertake to resell such debt*

obligation on the day of purchase or the next business day to a person other than a United States person.

A dealer who acquires a debt obligation in a transaction in which a written confirmation or comparison described in clause (i) is furnished shall not be entitled to a credit or refund under subsection (a)(2) with respect to his acquisition of such debt obligation unless he establishes that such debt obligation was sold by him on the day on which it was purchased or the next business day to a person other than a United States person.

"(B) OVER-THE-COUNTER SALES.—*For purposes of paragraph (1)(B), in the case of a claim for credit or refund under subsection (a)(2) with respect to a debt obligation sold in a transaction not on a national securities exchange, a written confirmation furnished by a member or member organization of a national securities association registered with the Securities and Exchange Commission stating that such member or member organization—*

"(i) *effected the purchase as broker of a debt obligation on behalf of a person other than a United States person, or*

"(ii) *purchased a debt obligation which he resold on the day of purchase or the next business day to a person other than a United States person,*

shall be conclusive proof that such debt obligation was sold to a person other than a United States person (unless the dealer relying upon the confirmation has actual knowledge that the confirmation is false in any material respect), if such association has in effect at the time of the purchase rules providing that a member or member organization who effects a purchase of, or purchases, a debt obligation from a dealer who notifies such member or member organization that such debt obligation is being sold by such dealer and that such dealer intends to claim a credit or refund under subsection (a) (2), shall furnish to such dealer a written confirmation stating that the purchase of such debt obligation was (or was not) effected by such member or member organization on behalf of a person other than a United States person, or that such debt obligation was (or was not) sold by such member or member organization on the day of purchase or the next business day to a person other than a United States person.

Paragraphs (1) and (2) of this subsection make clear that if two or more underwriters form a group for the purpose of distributing securities of a foreign issuer or obligor, any one member of the group may claim the credit or refund provided in this section for sales to foreign persons on behalf of the other members of the group. If the underwriter filing the claim on behalf of the group has not himself sold directly to foreigners, he may rely on certificates of sale to foreign

persons executed by the other underwriters, unless the filing underwriter has actual knowledge the certificates are false in any material respect. The essence of these two paragraphs now appear in subsection (b) in the present bill.

Paragraph (3) of this subsection is designed to provide a means under which a dealer claiming a credit or refund under section 4919 (a)(2) for the sale of foreign bonds to foreigners within 90 days after their purchase can establish the bonds were actually sold to foreigners.

The proposed provision establishes separate procedures to prove sale to a foreigner with respect to the over-the-counter and exchange markets because of the different characteristics of these markets. In the case of national securities exchanges, a dealer can establish sale to a foreigner if he sells in the special "F" market for foreign securities maintained by the exchange, provided the exchange has adopted the required rules. These rules must provide that a dealer acquiring bonds on the exchange in the special "F" market from another dealer who is claiming a credit or refund under section 4919(a)(2) must receive a special confirmation or comparison to this effect, and must undertake to resell the bonds to a foreigner on the date of purchase or the next business day. In the over-the-counter market, where transactions are on a negotiated basis, a dealer can establish sale to a foreigner by a confirmation received from a member of the National Association of Securities Dealers stating that the bonds were acquired by the member on behalf of a foreigner, or were sold by the member to a foreigner on the date of purchase or the next business day, provided the selling dealer has no actual knowledge the confirmation is false in any material respect and the association has adopted the requisite rules.

Section 4920. *DEFINITIONS; SPECIAL RULES*

(b) *Special Rule for Foreign Underwriters.* Following page 60, line 2.

The following is a new subsection (b). Present subsection (b) should become (c).

> "(*b*) *Special Rule for Foreign Underwriters.—A partnership or corporation which is not a United States person and which participates, as an underwriter in an underwriting group that includes one or more United States persons, in a public offering of stock or debt obligations of a foreign issuer or obligor shall, if such partnership or corporation so elects and subject to such terms and conditions as the Secretary or his delegate may prescribe by regulations, be treated as a United States person for purposes of this chapter with respect to its participation in such public offering.*

This new subsection is designed to afford uniform treatment to American purchasers of foreign securities in underwritings in which a foreign underwriter is participating together with U.S. underwriters.

Under the present provisions of the bill, the managing underwriter would be required to allocate to each U.S. purchaser the pro rata share of his purchase attributable to the foreign underwriter's participation. No certificate of American ownership could be given to

the customer with respect to this portion of his purchase, and interest equalization tax would be due. As a result, the underwriters would have to make the taxable portion available to Americans at a discounted price, in order to absorb the cost of the tax for the purchaser. The proposed amendment will permit the foreign underwriter to assume the tax burden directly, by electing to be treated as a U.S. person with respect to his participation, and thereby allow uniform pricing of the issue to U.S. purchasers. The proposal also will eliminate the necessity for individual U.S. purchasers to file returns and will simplify administration of the tax.

Section 2(c). *Effective Date.*

(2) *Preexisting commitments.* Page 60, line 13.

This paragraph should be amended as follows:

> Such amendments shall not apply to an acquisition—
>
> (A) made pursuant to an obligation to acquire which on July 18, 1963—
>
> (i) was unconditional, or
>
> (ii) was subject only to conditions contained in a formal contract under which partial performance had occurred;
>
> (B) as to which on or before July 18, 1963, the acquiring United States person (or, in a case where 2 or more United States persons are making acquisitions as part of a single transaction, a majority in interest of such persons) had taken every action to signify approval of the acquisition under the procedures ordinarily employed by such person (or persons) in similar transactions and had sent or deposited for delivery to the foreign [issuer or obligor] *person from whom the acquisition was made* written evidence of such approval in the form of a commitment letter, memorandum of terms, *draft purchase contract,* or other [signed] document setting forth *or referring to a document sent by the foreign person from whom the acquisition was made which set forth* the principal terms of such acquisition, subject only to the execution of formal documents evidencing the acquisition and to customary closing conditions;
>
> *(C) if, on or before July 18, 1963, the acquiring United States person—*
>
> *(i) had entered into a contract for the sale to the government of a less developed country or a political subdivision thereof, or an agency or instrumentality of such government, of property owned within such less developed country or political subdivision by such person or by a controlled foreign corporation (as defined in section 957) more than 50 percent of the total combined voting power of all classes of stock entitled to vote of which is owned (within the meaning of section 958) by such person, or of stock or debt obligations of such a controlled foreign corpora-*

tion which was actively engaged in the conduct of a trade or business within such less developed country; or had entered into a contract of indemnification with respect to the nationalization, expropriation, or seizure of such property or of such stock or debt obligations by the government of a less developed country or political subdivision thereof, or an agency or instrumentality of such government, or

(ii) had sent or deposited for delivery to the government of a less developed country or political subdivision thereof, or agency or instrumentality of such government, a commitment letter, memorandum of terms, or other document setting forth the principal terms of a contract described in clause (i),

to the extent such acquisition is required by the terms of the contract as a reinvestment within such less developed country of amounts equal to part or all of the consideration received under the contract; or

[C] *(D)* which would be excluded from tax under section 4915 of the Internal Revenue Code of 1954 but for the provisions of subsection (c) thereof, if (i) on or before July 18, 1963, the acquiring United States person applied for and received from a foreign government (or an agency or instrumentality thereof) authorization to make such acquisition and approval of the amount thereof, and (ii) such authorization was required in order for such acquisition to be made.

The purpose of this provision and the suggested changes are to exclude from tax acquisitions resulting from transactions which were completed or in advanced stages of negotiation on July 18, 1963. Application of tax to these acquisitions might create substantial hardship.

The proposed changes in subparagraph (B) make clear that a draft purchase agreement, which normally would not be signed by the lender, constitutes sufficient evidence of approval by the lender of the acquisition, provided that the draft purchase agreement was furnished to the borrower on or before July 18, 1963, and the lender had approved the acquisition in accordance with its customary procedures on or before that date. The changes also clarify that the acquisition need not be made directly from the foreign issuer or obligor, but can be made from another foreign person, so long as the other requirements of the provision are satisfied.

Proposed subparagraph (C) excludes from application of the tax the acquisition of stock or debt obligations pursuant to a contract or commitment entered into prior to July 18, 1963, under which a U.S. person sells property located in a less developed country (or stock of a company engaged in business in such a country) to, or receives indemnification from, such a less developed country (or its agency, instrumentality, or subdivision). This new provision is comparable to new section 4916(a)(4). Under both provisions, the companies in

which the U.S. person must reinvest would presumably qualify as less developed country corporations under the requirements of section 4916(c)(1). However, these companies are aware of the pressures on the U.S. person to reinvest the proceeds of sale, and they are not compelled to reveal the information regarding their assets and income which is necessary to establish compliance with the less developed country corporation provisions. This information is not otherwise available.

(7) DOMESTICATION. Page 63, line 22.

This paragraph should be amended to read as follows:

> Such amendments shall not apply to the acquisition by a domestic corporation of the assets of a foreign corporation pursuant to a reorganization described in subparagraph (*C*), (D) or (F) of section 368(a)(1) of the Internal Revenue Code of 1954 if the acquisition occurs on or before the 180th day after the date of the enactment of this Act and the foreign corporation was a management company registered under the Investment Company Act of 1940 from July 18, 1963, until the time of the acquisition.

This proposed amendment makes clear that a foreign investment company which domesticates within 180 days after enactment of this bill may do so in a reorganization under subparagraph (C) of section 368(a)(1) of the Internal Revenue Code as well as subparagraph (D) or (F) of that section.

Section 3. RETURNS

(a) MAKING OF RETURNS. Page 64, line 12.

(1) IN GENERAL. Page 64, line 19.

This paragraph should be amended to read as follows:

> "Every person shall make a return for each calendar quarter during which he incurs liability for the tax imposed by section 4911, or would so incur liability but for the provisions of section 4918. The return shall, in addition to such other information as the Secretary or his delegate may by regulations require, include a list of all acquisitions made by such person during the calendar quarter which are exempt under the provisions of section 4918, and shall, *with respect to each such acquisition, be accompanied either (A) by a certificate of American ownership which complies with the provisions of section 4918(e), or (B) in the case of an acquisition for which other proof of exemption is permitted under section 4918(f), by a statement setting forth a summary of the evidence establishing such exemption and the reasons for the person's inability to establish prior American ownership under subsection (b), (c), or (d) of section 4918* ⟦be accompanied by clear and convincing evidence showing that the acquisitions are so exempt⟧. No return or accompanying evidence shall be required under this paragraph in connection with any acquisition with respect to which a written confirmation, furnished in

accordance with the requirements described in section 4918 (c) or (d), is treated as conclusive proof of prior American ownership; nor shall any such acquisition be required to be listed in any return made under this paragraph.

This proposed amendment, like the suggested changes in section 4918 (a) and (b), is intended to facilitate the administration and enforcement of the interest equalization tax by requiring the filing of a certificate of American ownership with the quarterly tax return in order to prove the exemption for prior American ownership, unless the taxpayer can establish that his inability to file such a certificate is due to reasonable cause. No return or submission of proof is required if the acquisition was made through a member of a national securities exchange or the National Association of Securities Dealers who furnishes a confirmation to the purchaser which does not state that the purchase was subject to the tax. If a U.S. person is claiming the prior American ownership exemption but does not have the requisite certificate or confirmation, this proposed amendment requires him to attach a statement to his quarterly return setting forth a summary of the evidence establishing the exemption and the reasons for his inability to establish the exemption by means of a certificate or confirmation.

(3) REPORTING REQUIREMENTS FOR MEMBERS OF EXCHANGES AND ASSOCIATIONS. Page 65, line 20.

This paragraph should be amended to read as follows:

"*Every* member[s] *or* [of] member organization[s] of *a* national securities exchange[s] *or of a* [and] national securities association[s] registered with the Securities and Exchange Commission shall keep such records and file such information as the Secretary or his delegate may by regulations prescribe in connection with *acquisitions and* sales effected by such member[s] or member organization[s] as *a* broker[s], and acquisitions made for [their own accounts,] *the account of such member or member organization*, of stock or debt obligations—

"(A) as to which a certificate of American ownership or blanket certificate of American ownership is executed and filed *with such member or member organization as prescribed under* [as described in] section 4918(e)*; and*

"*(B) as to which a written confirmation is furnished to a United States person stating that the acquisition—*

"*(i) in the case of a transaction on a national securities exchange, was made subject to a special contract, or*

"*(ii) in the case of a transaction not on a national securities exchange, was from a person who had not filed a certificate of American ownership with respect to such stock or debt obligation or a blanket certificate of American*

ownership with respect to the account from which such stock or debt obligation was sold.

The suggested additions to the recordkeeping requirements for brokers are essential to provide necessary enforcement procedures for collection of the proposed tax.

Under the bill, a broker who sells on behalf of a customer in the regular market and who does not advise the purchasing broker that he is acting on behalf of a foreigner, permits the purchasing broker to supply a confirmation to the purchaser which is conclusive proof of an exemption from the tax. Such selling brokers are required to retain appropriate records in connection with these transactions. In addition, brokers acting on behalf of the purchaser and seller in taxable transactions should also be required to maintain necessary records. Without such information and records, administration of the tax would be seriously handicapped.

Section 5. *Original Issue Discount*

This is a new section which should begin on page 67, line 17. Present section 5 (Penalties) should be renumbered section 6. Section 5 should provide as follows:

> *"Section 1232(b)(2) (relating to definition of issue price) is amended by inserting before the period at the end of the second sentence thereof the following: 'increased by the amount, if any, of tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer.'*

This new section is designed to remove the possibility that the purchaser of a debt obligation in a private placement might suffer adverse income tax consequences because of the interest equalization tax.

The purposes of the proposed tax have no relation to the treatment under section 1232 of the Internal Revenue Code of the part of the gain on a sale or exchange of debt obligations consisting of "original issue discount," and allocable to the period the taxpayer held the securities, as ordinary income. In the case of a private placement of debt obligations of a foreign issuer, where the amount of tax payable by a United States purchaser is reflected in a deduction from the purchase price, the amount of the discount might produce original issue discount and subject the purchaser and subsequent purchasers to possible additional ordinary income taxes. The proposed new section would avoid that unintended result.

Section 6. Penalties

Section 6681. FALSE EQUALIZATION TAX CERTIFICATES. Page 68, line 13.

(d) *False Confirmations or Comparisons Furnished by Dealers.* Page 70, line 11.

This is a new subsection (d); present subsection (d) becomes (e).

> *"(1) MEMBERS OF NATIONAL SECURITIES EXCHANGES.—A member or member organization of a national securities exchange described in section 4919(b)(3)(A) who, in a transaction subject to the rules of such exchange as described in such section, wilfully furnishes a written confirmation or comparison which*

contains a misstatement of material fact or which fails to state a material fact shall be liable to a penalty equal to 125 percent of the amount of the tax imposed by section 4911 on the acquisition of the debt obligation by the dealer for whose benefit such confirmation or comparison is furnished.

"(2) Dealers.—Any person who sells as a dealer a debt obligation in a transaction subject to the rules of a national securities exchange as described in section 4919(b)(3)(A), in which such sale is effected on his behalf by a member or member organization of such exchange, and who wilfully fails to disclose to such member or member organization that such sale is being made by him as a dealer, shall be liable to a penalty equal to 125 percent of the amount of the tax imposed on his acquisition of the debt obligation with respect to which such confirmation or comparison is furnished.

"(3) Members of national securities associations.—A member or member organization of a national securities association described in section 4919(b)(3)(B) who wilfully furnishes a written confirmation described in such section (in a transaction subject to the rules of such association as described in such section) which contains a misstatement of material fact or which fails to state a material fact shall be liable to a penalty equal to 125 percent of the amount of the tax imposed by section 4911 on the acquisition of the debt obligation by the dealer for whose benefit such confirmation is furnished."

This new subsection provides penalties for members of national securities exchanges and the National Association of Securities Dealers who willfully violate the procedures set forth in section 4919(b)(3). That section permits a dealer claiming a credit or refund under section 4919(a)(2) (for the sale of foreign bonds to foreigners within 90 days after their purchase) to establish the bonds were actually sold to foreigners. The procedures in the over-the-counter market and on the exchanges require that the confirmations or comparisons furnished to the dealer on which the claim for credit or refund are based be truthful. This new subsection imposes a 125-percent penalty on a member or dealer who wilfully furnishes a false confirmation or comparison or who wilfully fails to disclose that he is acting as a dealer in a transaction described in section 4919(b)(3), since the false document or statement permitted a credit or refund to be obtained improperly.

Senator DOUGLAS. It is a pleasure to welcome the Secretary of the Treasury who is here at our invitation to discuss H.R. 8000, the Interest Equalization Tax Act of 1963.

We are very glad to have you, Mr. Secretary; again I want to say that I always admire the way in which you sit at the table and present a complicated subject on your own initiative without being flanked by enormous numbers of advisers and without being compelled to turn to them on the questions which we ask.

This is really unique.

Senator CARLSON. Mr. Secretary, don't get carried away by this praise early in this session.

Secretary DILLON. We have had plenty around to date before, Mr. Chairman.

Senator WILLIAMS. It could be the quality of our questions. [Laughter.]

STATEMENT OF HON. DOUGLAS DILLON, SECRETARY OF THE TREASURY

Secretary DILLON. Mr. Chairman and members of the Committee on Finance, I am appearing before you today in support of H.R. 8000, the interest equalization tax, which passed the House of Representatives with a large majority on March 5 of this year.

This tax was originally proposed by President Kennedy last July in his special message on the balance of payments. It has since been fully supported by President Johnson. I also favor adoption of the technical amendments suggested in my letter to the chairman of June 12, which have been reprinted by your committee and placed in the record of this hearing.

A year ago, our balance of payments was deteriorating sharply. That deterioration was due almost entirely to accelerating capital outflows, and particularly to an unprecedented outflow of portfolio capital. The rate at which new issues of foreign securities were being purchased had more than tripled in the previous 18 months, and the volume during the first 6 months of 1963 reached a total of $1 billion.

As a result, the deficit in our international accounts—apart from all special intergovernmental transactions—jumped from the already high 1962 level of $3.6 billion to an annual rate of $5.3 billion in the second quarter of 1963. If allowed to continue, that deficit would have undermined the international stability of the dollar.

Today our balance of payments situation is much improved and the dollar is strong. Judging from data at hand, the deficit for the fiscal year ending tomorrow, calculated on the same basis—this is regular transactions—will be well under half that of the preceding fiscal year.

Paralleling this improvement, confidence has been restored in our ability to achieve a balance in our payments within a reasonable time. This, in turn, has stanched the drain on our gold stock. After declining by an average of $1.7 billion a year over the 1958–60 period, and by roughly half that rate during 1961 and 1962, our total gold stock today is virtually unchanged from 10 months ago—by far the longest period of stability during the past 6 years.

However, we must not succumb to any illusion that the progress of the past year means the end of our longstanding balance of payments

problem or allows us in any way to relax our drive toward equilibrium. The hard fact is that after 6 consecutive years of large deficits—adding up to a total of $21½ billion on the basis of regular transactions—we face once again this year the unhappy task of financing a sizable, even though substantially reduced, imbalance in our payments.

Roughly half of our payments improvement for the past 12 months can be traced directly to diminished outflows of capital into foreign securities.

But the basic problems giving rise to the enormous capital outflow in 1962 and early 1963 have not yet been solved. Were we not now to proceed with enactment of the proposed interest equalization tax, demands from abroad for portfolio capital would once again quickly converge on our market in a volume far larger than we could sustain.

We simply cannot afford to pay the price such an event would exact in terms of dangers for the dollar and losses of gold and confidence—thus undercutting our whole international financial position.

THE NEED FOR THE TAX

The need for the interest equalization tax has arisen out of a combination of circumstances here and abroad that led to a rapid acceleration in foreign demands on our capital market.

In the short space of the first 6 months of 1963, purchases of new foreign issues—the overwhelming bulk from other industrialized countries—reached a seasonally adjusted annual rate of $1.9 billion. That was $800 million higher than the already swollen 1962 total and 3½ times the 1961 level.

In addition, the indications were that potential borrowers in Europe and Japan, who had already increased their demands on our market dramatically, were scheduling still larger borrowings in this country.

This surging flow of foreign borrowings simply swamped the real progress in other areas of our balance of payments. As a result, our overall deficit on regular transactions rose to an annual rate of $5 billion during the first half of 1963, sharply above the totals of $3.1 and $3.6 billion in 1961 and 1962, respectively. These increases, as shown by tables 1 and 2, paralleled the swelling outflow of portfolio capital into new foreign securities.

This rise in the outflow of portfolio capital reflected neither financing of U.S. exports nor the more general balance of payments needs of the borrowing countries.

On the contrary, more and more of the new flotations in our market were designed to finance local projects of businesses or governments in countries already enjoying relatively strong or improving external positions.

Many of the new borrowers did not require foreign exchange, but only desired greater amounts of fresh capital to support their own internal growth. Because their own capital markets were both narrow and costly, those borrowers desiring funds were naturally attracted by our relatively low long-term interest rates and by the ease with which large amounts of funds could be obtained in our well-developed market.

As a result, a large portion of the outflow of portfolio capital, by providing more dollars to those who simply wished to exchange those dollars for their own currencies, was adding roughly equivalent amounts to our deficit. The dollars in turn were flowing into central banks and becoming a claim on our gold.

Appraising the same facts from a European vantage point, the most recent annual report of the Bank for International Settlements, which came out about 3 weeks ago, came to the same conclusion. That report, which is representative of responsible and official European opinion, noted, in speaking of 1963, that—

* * * instead of being a net exporter of capital, which would seem the appropriate structural position, Europe was a large net importer of capital—which in the main has been flowing into reserves.

Purchases of foreign portfolio securities by Americans do in time lead to a return flow of interest and dividend income. But this potential return is spread over many future years, while the entire outflow of principal is immediate.

For instance, during both 1962 and 1963, years when the outflow of U.S. portfolio capital into foreign securities averaged about $1¼ billion, the increase in our income from such securities amounted to only about $50 million a year.

Clearly, calculations of earnings possibilities many years in the future cannot, in the situation we face, substitute for the urgent need to protect the dollar by bringing the current portfolio capital outflow within the limits of our immediate capacity to lend.

THE NATURE OF THE INTEREST EQUALIZATION TAX

In the light of these circumstances, prompt and effective action to reduce the outflow of portfolio capital was essential. The proposal before this committee is designed to achieve that result by means of an excise tax levied on the American acquiring directly from a nonresident foreigner a foreign stock or debt issue maturing in more than 3 years. While the tax is payable by the American purchaser, the impact will be effectively passed on to the foreign issuer in reduced prices for his securities.

The rate of tax is graduated so that its net effect is to increase by about 1 percent the annual cost of capital to a foreigner raising money in our market, thus bringing this cost to a level more comparable to the costs he would face abroad.

The result of foreigners would thus be similar to an increase of 1 percent in our entire structure of long-term interest rates.

Finding our market more costly, many potential foreign borrowers will seek the funds they require at home, or in other foreign markets, instead of aggravating the strains on our own position.

Similarly, American investors will find the net yield on American securities relatively more favorable than yields provided on outstanding foreign securities purchased from foreigners, and will tend correspondingly to reduce their purchases of such securities.

We view the proposed tax purely as a transitional measure. As our own payments come into equilibrium, as the expansion in our own economy reduces incentives to export our capital, and as the capital markets of other advanced countries develop the capability of more

adequately meeting their internal needs, this special tax can and should be removed.

H.R. 8000 contains a termination date of December 31, 1965, to assure that it will not be prolonged beyond the time of need.

At the same time, because of the urgency of dealing with the problem, President Kennedy proposed that this tax become generally effective July 19, 1963, the day following its announcement in his special message on the balance of payments. Any other course would simply have been an open invitation for potential borrowers and lenders to accelerate their plans and crowd into our market before the effective date of the tax. Our balance of payments most certainly could not have borne such a strain.

On the other hand, making that proposed effective date known to the market has permitted careful congressional consideration of this important piece of legislation without the atmosphere of haste and urgency which would inevitably have developed in the face af accelerating capital outflows.

The House, in approving this proposed date, recognized that any other course would only have rewarded those few who have been willing to gamble on the possibility that a later effective date would be enacted, at the expense of the great majority who have already adjusted their transactions in the light of the proposed July 1963 effective date.

Transactions in foreign securities between residents of the United States would not be subject to tax, and Americans would, of course, be able to sell foreign securities free of tax to foreigners in markets both here and abroad.

Thus, active trading markets in the more than $12 billion of foreign securities already held by Americans will be maintained, and these securities will fully maintain their value. The passage of time since last summer has clearly proved that the provisions of the tax regarding outstanding securities are workable, and that they contribute substantially toward improving our payments position.

The proposed bill would exempt a variety of acquisitions from foreigners where this is possible without undermining the effectiveness of the tax and where imposition of the tax would work at cross purposes with other objectives.

The exclusion from the tax of obligations maturing within 3 years assures that the great bulk of our export financing and normal recurring international business will not be impeded. Further to assure unimpeded export financing, longer term export paper is specifically exempted, as are bank loans made in the ordinary course of business.

Other important exemptions would be provided for the governments and businesses of less developed countries and for direct investment. In addition, the President would be provided discretionary authority to exempt in whole or in part new issues from a particular country in those instances in which he determines that application of the tax would imperil, or threaten to imperil, the stability of the international financial system. This exemption is designed as a kind of safety valve for use only when it can be clearly established that, as a direct consequence of the tax, a foreign country would be forced to take such drastic measures that international financial stability would be imperiled.

Any such showing would be dependent upon a highly unusual set of circumstances, and in my opinion the necessary conditions are today met only by Canada.

An annex to this statement describes the provisions of the bill more fully, while a detailed summary and a technical explanation of the bill are contained in the report of the Ways and Means Committee of the House.

BALANCE-OF-PAYMENTS IMPACT

The effectiveness of the proposed tax in reducing the outflow of portfolio capital—and the key importance of this in terms of the entire balance of payments—is clearly revealed by the results since last July.

After running at a rate of $5 billion during the 6 months prior to the President's message in July 1963, the deficit on regular transactions dropped sharply to a rate of $1.6 billion during the second half of 1963 and to $700 million during the first quarter of 1964.

The first quarter results reflect a number of special factors which had the effect of substantially but temporarily reducing the deficit. Among these was an unusual and temporary short-term capital inflow during March that was fully reversed early in April, thus adding to the deficit being incurred during the current quarter.

A number of factors, including a sizable rise in exports, have contributed to the improvement in our balance of payments since last July. However, the single, largest element in this improvement is the sharp decline in net purchases of foreign securities.

Comparing the 9 months before the tax was proposed with the 9 months since that time for which full data are available, the outflow into foreign securities dropped from $1,985 million to $290 million at seasonally adjusted annual rates, a reduction of $1.7 billion in the annual rate of outflow.

To some extent, these gains were exaggerated by the initial uncertainties regarding the precise provisions of the tax. These uncertainties could not be expected to last, nor would this be desirable. Our market will not be closed. Some foreigners will borrow in this country and absorb the tax; others will enter our market in the knowledge that their issues will be exempted. There are clear signs that activity resumed on this basis during recent months, and the outflow into foreign securities is therefore expected to increase moderately.

However, the experience of the past 9 months confirms our belief that the proposed tax will be effective in confining this outflow to substantially lower levels than those of late 1962 and early 1963.

During the hearings before the Ways and Means Committee last fall, the Treasury estimated that imposition of the tax would result in an overall reduction in the net purchase of foreign securities of $1¼ to $1½ billion a year. These savings were calculated from the high levels of outflow during the 6 to 9 months preceding the tax.

The validity of these estimates is now strongly supported by the figures at hand—a saving at an annual rate of $1.7 billion in the 9 months following announcement of the proposed tax as compared to the preceding 9 months.

Such estimated savings are fully consistent with purchases of new foreign issues at a rate of perhaps $600–$800 million a year—close to, but still somewhat above, the rate that would have been considered "normal" prior to 1962.

Furthermore, such a total would be consistent with needed progress toward equilibrium in our balance of payments, without putting undue strain on the international financial system.

Already a sizable number of new issues have been diverted to European markets, where they have been absorbed by countries in a strong balance-of-payments position. Under the stimulus of the tax, European markets have shown that they are capable both of handling their own internal needs in more adequate fashion and of meeting a larger portion of foreign needs.

I want to emphasize that an exemption for new Canadian issues should not impair the effectiveness of the tax. Canadian authorities have assured us that it is their intention that Canadian borrowing in our market will not exceed amounts necessary to maintain reasonable equilibrium in Canada's international reserve position.

This should mean a substantial reduction in Canadian borrowing in this country from the exceptionally high levels of late 1962 and early 1963 to the more normal levels that were characteristic of earlier years. Certainly, over the period since the tax has been proposed, the Canadian reserve position has not deteriorated despite a sharply lower level of borrowings in our market.

We have, of course, also been closely following trends in bank lending, in view of the possibility that foreign borrowers might seek to shift to that kind of financing. While analysis of detailed information supplied by the banks on their commitments for the first 5 months of 1964 does not suggest any significant direct substitution for market financing, the total volume of short- and long-term outstanding rose sharply in 1963 and during the first quarter of 1964. The rise started early in the spring of 1963 and became particularly noticeable during the fourth quarter.

A good part of this increase is clearly related to the surge in American exports over the same period. But, in addition, it is possible that, in adjusting to the tax, borrowers in a few countries under balance-of-payments pressure—notably Japan—have made greater use of bank loans. While some initial reactions of this kind are not surprising, and there are now some indications of a leveling off of the loan volume, future trends will clearly require continuing surveillance. We will promptly recommend to the Congress appropriate changes in the bank loan exemption should it appear that such loans are in fact being utilized to any significant degree as substitutes for market financing.

THE TAX AND OUR OVERALL BALANCE-OF-PAYMENTS PROGRAM

This tax is only part—although a crucial part—of a comprehensive balance-of-payments program. A satisfactory long-run solution for our payments problem depends on a more vigorous and efficient domestic economy, capable of sustained productive expansion with stable costs and prices.

Major steps to support this objective were taken in 1962 with the investment tax credit and the liberalization of depreciation allowances. They were followed this year by the $11.5 billion reduction in individual and corporate tax rates.

Together with responsible wage bargaining and pricing policies, these fiscal measures are now strengthening our basic competitive position at home and abroad, and our basic trade outlook is favorable.

Greater prosperity at home, with greater profitability of investment here relative to the returns available from foreign investment, will reduce the incentive for direct investment abroad and encourage the retention of funds at home where their investment in domestic projects will create more jobs for Americans.

We have also placed great emphasis upon reducing the net flow of dollars abroad as a result of Government programs. For example, between 1960 and mid-1963, our annual rate of net military expenditures abroad was reduced by more than $500 million.

That portion of our economic assistance provided by AID in the form of U.S. goods and services rather than dollars has been raised from less than one-third in 1960 to over 80 percent for current commitments.

President Kennedy last July scheduled an additional reduction of $1 billion in the annual rate of oversea governmental expenditures by the end of this year. President Johnson is determined to achieve that target.

As you can see, visible gains are being made toward solving our basic payments problem. But we must not permit them to be drained away in a renewed outflow of portfolio capital.

ALTERNATIVES TO THE TAX

While appreciating the need to restrain the outflow of portfolio capital, some have suggested that there are preferable alternatives to the tax.

One would be an attempt to drive up our entire structure of long-term interest rates by about 1 percent. Such a drastic tightening of credit, if possible at all, would clearly work against all that we are trying to achieve to reduce excessive unemployment and encourage the investment that creates jobs and promotes efficiency.

The interest equalization tax increases the cost of our money to foreigners, just as would a sharp increase in our own rates. But it will do so without the disrupting effects on the entire domestic economy of an attempt to artifically force our long-term rates to unrealistically high levels.

Another suggested alternative would abandon the market system altogether by rationing credit to foreigners through a capital issues committee. Proponents of that approach have failed to suggest what kind of criteria could be used to cut back the heavy foreign demands for capital, or whether any rational criteria could be consistently applied amid the conflicting pressures from at home and abroad that would descend upon those administering the system.

To be successful, a capital issues committee would have to be Government controlled. This would mean that Government—substituting case-by-case decisions by the Executive for the market effects of the proposed tax—would have to intrude itself directly into the process of individual decision making in a way that this country has never found acceptable save in wartime.

Moreover, selective rationing would clearly not be workable in the case of outstanding securities. There are simply too many transactions in this area, through too many channels, to make policing practicable on a case-by-case basis.

Substantial balance-of-payments savings would be sacrificed and, if equal overall savings were to be achieved, the volume of new issues would have to be held to a considerably lower figure than is expected under the interest equalization tax.

CONCLUSION

The administration has proposed this temporary tax with reluctance, but the need for action to restrain the outflow of portfolio capital is clear. The workability and effectiveness of our approach have been demonstrated. It is far preferable to any alternative that has been suggested.

Our international competitive position is strengthening, and other measures to achieve lasting improvement in our payments are bearing fruit. But these measures take time, and meanwhile our deficit remains sizable.

Failure to enact this tax would stimulate a resurgence of capital outflows with dire effects on our balance of payments.

Also, such failure could only be interpreted throughout the world as an unwillingness on the part of the United States to face up to the hard decisions that are required to protect the dollar, and so the financial health of the entire free world. I therefore strongly urge your early approval of this vitally important legislation.

Thank you, Mr. Chairman.

(The tables and annex accompanying Secretary Dillon's statement follow:)

TABLE 1.—*U.S. balance of payments, 1960 to 1st quarter 1964*[1]

[In millions of dollars]

	1960	1961	1962	1963			1964, 1st quarter (seasonally adjusted annual rates)
				Seasonaly adjusted annual rates		Total	
				1st half	2d half		
Commercial merchandise exports	17,545	17,693	18,213	18,098	20,338	19,218	21,880
Commercial merchandise imports	−14,723	−14,497	−16,134	−16.428	−17,434	−16,931	−17,388
Commercial trade balance	2,822	3,196	2,079	1,670	2,904	2,287	4,492
Commercial services, remittances, and pensions	856	1,583	1,739	1,200	1,484	1,342	2,460
Commercial balance [2]	3,678	4,779	3,818	2,870	4,388	3,629	6,952
Military expenditure (net) [3]	−2,712	−2,560	−2,375	−2,188	−2,360	−2,274	−1,988
Government grants and capital dollar payments	−1,110	−1,139	−1,077	−1,010	−762	−886	−560
Government capital receipts, excluding prepayments, borrowings and fundings	543	516	501	388	502	445	540
Private capital:							
Transactions in foreign securities	−864	−910	−1,172	−2,112	−438	−1,275	8
Other long-term [4]	−1,243	−1,267	−1,437	−1,784	−2,042	−1,913	−2,716
Short-term	−1,438	−1,492	−752	−998	−454	−726	−2,528
Unrecorded transactions	−772	−998	−1,111	−164	−408	−286	−432
Balance on regular transactions	−3,918	−3,071	−3,605	−4,998	−1,574	−3,286	−724
Special Government transactions [5]	37	701	1,402	1,258	1,430	1,344	556
Overall balance	−3,881	−2,370	−2,203	−3,740	−144	−1,942	−168
Memorandum: Gold sales (not seasonally adjusted)	1,702	857	890	[6] 227	[6] 234	461	[6] 46

[1] Excludes military transfers under grants.
[2] Excluding exports and services financed by Government grants and capital.
[3] Excludes advances on military exports.
[4] Including direct investment.
[5] Includes nonscheduled receipts on Government loans, advances on military exports, and sales of nonmarketable medium-term securities, including convertible securities of $502,000,000, 1st half 1963; $200,000,000, 2d half 1963.
[6] Not at annual rates.

Source: Survey of Current Business.

TABLE 2.—*Long-term capital flows in the U.S. balance of payments, 1960 to 1st quarter 1964*

[In millions of dollars]

	1960	1961	1962	1963: Seasonally adjusted annual rates, 1st half	1963: Seasonally adjusted annual rates, 2d half	1963: Total	1964, 1st quarter (seasonally adjusted annual rates)
Direct investment:							
U.S. direct investment abroad	−1,674	−1,599	−1,654	−2,064	−1,660	−1,862	−1,852
Foreign direct investment in United States	141	73	132	88	−54	17	96
Net direct investment	−1,533	−1,526	−1,522	−1,976	−1,714	−1,845	−1,756
Portfolio investment:							
U.S. purchases of new issues of foreign securities	−555	−523	−1,076	−1,858	−680	−1,269	−388
U.S. net purchases of outstanding foreign securities	−309	−387	−96	−254	242	−6	396
Total purchases foreign securities	−864	−910	−1,172	−2,112	−438	−1,275	8
Redemptions of U.S.-held foreign securities	201	148	203	186	204	195	176
Other U.S. long term, net[1]	−200	−263	−258	−312	−816	−564	−1,088
Foreign long-term portfolio investments in United States	289	374	140	318	284	301	−48
Net portfolio investment	−574	−651	−1,087	−1,920	−766	−1,343	−952
Net long-term capital	−2,107	−2,177	−2,609	−3,896	−2,480	−3,188	−2,708

[1] Mainly long-term bank loans.

Source: Survey of Current Business and Department of Commerce.

TABLE 3.—*New issues of foreign securities purchased by U.S. residents by area, 1960 to 1st quarter 1964*

[Millions of dollars]

	1960	1961	1962	1963: 1st half	1963: 2d half	1963: Total	1964 1st quarter
Canada	221	237	457	682	105	737	91
Western Europe	24	57	195	219	53	272	----------
Japan	15	61	101	83	57	140	----------
Other developed[1]	27	43	60	17	----------	17	----------
Latin American Republics	107	18	[2] 102	13	23	36	13
Other less developed	64	95	77	35	32	67	24
International institutions	97	12	84	----------	----------	----------	4
Total new issues	555	523	1,076	999	270	1,269	132

[1] Australia, New Zealand, South Africa.
[2] Includes $75,000,000 issues by Inter-American Development Bank.

Source: Survey of Current Business and Department of Commerce.

TABLE 4.—*U.S. transactions in foreign securities, 9 months before and after interest equalization tax*

[Millions of dollars]

	Seasonally adjusted annual rates		Improvement
	October 1962 to June 1963	July 1963 to March 1964	
U.S. net purchases of foreign securities:			
New issues	−1,853	−583	+1,270
Outstandings	−132	+293	+425
Total	−1,985	−290	+1,695

Source: Department of Commerce.

ANNEX. GENERAL DESCRIPTION OF THE INTEREST EQUALIZATION TAX

NATURE OF TAX

The interest equalization tax is a temporary excise tax imposed on acquisitions by Americans of foreign securities from foreigners regardless of where the acquisition occurs. The tax applies to foreign stock and debt obligations, both new and outstanding. It does not apply to purchases of foreign securities by Americans from other Americans.

By bringing the costs to foreigners of raising capital in the U.S. market more closely into line with costs prevailing in foreign capital markets, the tax will substantially reduce the incentives to foreigners to raise capital in the U.S. market because of lower interest rates in this country. The higher cost to foreigners resulting from the tax, however, is not intended to eliminate all outflows of portfolio capital; long-term U.S. capital will remain available to those foreigners whose urgent need for such funds cannot be met on reasonable terms in foreign capital markets.

Rate.—The rate of the tax in the case of foreign debt obligations is graduated from 2.75 percent for obligations maturing in 3 years to 15 percent of those maturing in 28½ years or more. The schedule of rates is determined so as to increase by roughly 1 percent the cost of borrowing to the foreigner. In the case of foreign stocks, the rate of the tax is 15 percent, the same as for bonds of the longest maturity.

New and outstanding securities.—The tax applies broadly to both new stocks and debt obligations and outstanding stocks and debt obligations. Coverage of transactions with foreigners in all of these categories is consistent with the intent that the tax operate in a manner analogous to a general rise in U.S. long-term interest rates, and assures that strong incentives and opportunities will not arise for funds to flow out through tax-free channels, undermining the effectiveness of the tax.

Short-term obligations.—No tax is imposed on the acquisition of debt obligations if the period remaining to maturity is less than 3 years. This exemption will permit the wide variety of short-term credit transactions related to international trade generally and U.S. exports in particular to continue unaffected. Transactions in short-term instruments occur in enormous volume and take a wide variety of forms, but most of them relate to trade financing and to normal, reversible shifts of funds between markets in response to temporary needs and short-term, interest-rate differentials. Since interest rates for short-term loans in the United States can more readily be influenced by monetary policy, without adverse effect on the economy in general, it has been possible to bring these rates more closely into line with those prevailing in other important industrialized nations.

EXCLUSIONS

In addition to the basic exemptions from the tax of acquisitions of short-term obligations and acquisitions from other Americans, the bill provides various exclusions so as not to interfere with certain vital national objectives, such as the encouragement of U.S. exports, the avoidance of threats to the stability of the international monetary system, and the growth of less-developed countries. The major categories of exclusions are described below.

Export financing.—One of the best methods of reducing the deficit in the U.S. balance of payments is to increase exports from this country. Accordingly, the bill provides for a series of specific exclusions for stock and debt obligations acquired in connection with various export transactions. These exclusions will assure that American business firms have the ability to offer credit facilities to their foreign customers, whether for short- or long-term loans.

The acquisition of debt obligations is excluded from tax if they are guaranteed or insured by the Export-Import Bank or other U.S. Government agencies or instrumentalities. In addition, debt obligations acquired by Americans in connection with the sale of U.S. goods (tangible or intangible) abroad are free of the tax, as is the acquisition of stock or debt obligations in connection with a foreign project in which American firms participate to a substantial degree. The bill also excludes from the tax debt obligations acquired by an American firm from foreign customers when the proceeds are used for the installation or maintenance of facilities to service goods sold by the American firm which were produced, grown, or extracted in the United States. A similar exclusion has also been provided where the U.S. firm is engaged in selling ores or minerals in which it has a substantial economic interest, whether or not extracted in the United States.

Commercial bank loans.—Commercial banks making loans in the ordinary course of their commercial banking business would not be subject to tax. Most of these loans would ordinarily be excluded because of their short maturities, and much of short-term bank financing of foreigners involves exports. The exclusion, besides permitting banks to continue freely their role in financing U.S. exports, enables them to maintain their flexibility in meeting normal, recurring needs for financing international business.

Experience under this exclusion will be closely observed. In order to provide detailed information as to whether the exclusion for commercial bank loans should be continued and, if not, the ways in which the exclusion should be changed, the bill provides for authority to require banks to furnish relevant data on their loans to foreigners.

International monetary stability.—The bill gives the President authority to exempt all or a portion of new security issues of a foreign country from tax where he determines that application of tax to such securities imperils, or threatens to imperil, the stability of the international monetary system. This is consistent with our treaty obligations to the International Monetary Fund.

Use of this exclusion would be justified only in highly unusual circumstances. New issues of Canadian securities are the only ones which, under present circumstances, it is contemplated would be excluded under this provision.

Less-developed countries.—The tax is not applicable to the acquisition of securities issued or guaranteed by less-developed countries nor to the acquisition of securities issued by less-developed country corporations. At the present time, it is expected that this exclusion would apply to the securities of all Latin American countries, African countries with the exception of South Africa, Asian countries except for Japan and Hong Kong, and to a few other nations outside the Sino-Soviet bloc. This exclusion is designed to help those countries with chronic capital shortages, urgent development needs, and limited ability to borrow on normal commercial terms. The United States has long recognized a responsibility for assisting these nations in their struggle to achieve improved standards of living, and application of the tax to issues of these countries would work against these objectives.

Direct investments.—The tax is not applicable to direct investments in oversea subsidiaries and affiliates. Direct investment means the acquisition of stock or a debt obligation in a foreign corporation or partnership by an American owning at least 10 percent voting control after the transaction is completed. The exclusion of these transactions is based on the fact that the decision to make such investments is usually grounded in such factors as market position and long-range profitability rather than interest-rate differentials.

Foreign corporations controlled by Americans and traded here.—The bill treats as domestic a foreign corporation traded on an American stock exchange, if trading on U.S. exchanges provides the principal market for the stock and if more than 50 percent of the stockholders were Americans on July 18, 1963. Close association of these companies with the United States justifies their treatment as domestic companies.

Insurance companies with foreign business.—The bill permits insurance companies to acquire stock and debt obligations of foreign issuers and obligors tax free in an amount equal to 110 percent of their reserves against foreign risks in

connection with their operations in foreign countries. This exemption is based on the fact that U.S. insurance companies often engage in business in foreign countries through branch operations, and in conducting this business, they receive premiums in a foreign currency, invest the proceeds in that currency, and are required to pay liabilities on policies in that currency. Since the absence of an exclusion of this character would expose the insurance companies to a foreign exchange risk, it was believed desirable to provide this exclusion.

Labor unions, etc.—The bill exempts acquisitions by labor unions and certain other tax-exempt organizations which hold dues or membership fees in foreign currency for the benefit of local members located in foreign countries. This exclusion, as with insurance companies, avoids exposing these organizations in the ordinary conduct of their operations to a foreign exchange risk.

Underwriters and dealers.—To facilitate and encourage the placement of new foreign issues abroad, American underwriters participating in the distribution of new foreign issues would receive a credit or refund of the tax on any sales to foreigners. Similarly, dealers maintaining markets in foreign bonds will be given a credit or refund on such securities purchased from foreigners and resold to foreigners within 90 days after their purchase. A similar provision has been proposed to apply to arbitrage transactions by dealers in foreign stocks as long as the dealer sells to a foreign person on the same day the stock is purchased. The shorter time provision for stocks, as compared with bonds, is a recognition of the fact that stocks could become a tax-free vehicle for speculation under any wider exclusion.

The credit or refund provision for underwriters and dealers will provide incentives to place a maximum portion of new flotations of foreign securities in foreign hands, and will assure potential foreign buyers that an active secondary market will be available in this country for such new foreign bonds as they may purchase.

Acquisitions required by foreign law.—The bill provides an exclusion from tax in the case of securities acquired by an American firm doing business in a foreign country to the extent the acquisitions are reasonably necessary to satisfy minimum requirements relating to holdings of foreign securities imposed by the laws of the foreign country. This exemption is provided because some foreign countries require foreign businesses engaged in business locally to invest a portion of their assets in securities of that country as a condition to doing business there.

OTHER PROVISIONS

Liability for tax.—The tax is imposed on the U.S. person acquiring a foreign security from a foreigner. The purchaser who is liable for the tax must file a quarterly interest equalization tax return listing taxable purchases and enclosing payment.

Administrative procedure.—A simple administrative procedure has been established for determining when the tax is owed. If the U.S. purchaser is buying through a U.S. broker and his purchase confirmation does not indicate that his purchase is subject to the tax, the confirmation is proof of his exemption and no return is required. If the purchase is not made through a U.S. broker, the purchaser should receive a certificate of American ownership from the seller if the seller is a U.S. person. The certificate is proof of the purchaser's exemption. Stock exchanges and over-the-counter markets have developed procedures which readily permit the operation of these provisions.

Effective date and expiration date.—The bill generally is effective with respect to acquisitions by Americans of foreign securities from foreigners made on or after July 19, 1963. This is 1 day after the date Congress received the President's special message on the balance of payments and the public announcement of the principal features proposed by the administration for this bill. A special effective date of August 17, 1963, is provided for foreign securities traded on an exchange so as to permit uninterrupted trading in foreign securities on the exchanges, while they were adjusting their trading rules and procedures to the requirements of the proposed bill. The bill also exempts certain transactions which were in an advanced stage of negotiation on July 18, 1963, since application of the tax to these transactions might have created substantial hardships.

The tax would expire December 31, 1965.

REVENUE EFFECT

It is estimated that this bill will result in a revenue gain of up to $30 million on an annual basis.

Senator DOUGLAS. Thank you for a characteristically able statement, Mr. Secretary.

You state that the deficit in the balance of payments for the fiscal year which will end tomorrow, June 30, 1964, is about half that of the preceding fiscal year. I wondered if you would give these figures in absolute terms?

Secretary DILLON. Well, I stated it would be well under half because we don't have the figures for this year, and will not have them in any really useful form for another month or so, and I was being very conservative. The figure for the last fiscal year was about $4½ billion, and we expect to be very substantially under half of that during this fiscal year.

Senator DOUGLAS. To hazard a guess, would the deficit be around $2 billion this year?

Secretary DILLON. Around $2 billion, maybe a little less.

Senator DOUGLAS. I wondered if it would be possible for you to submit at a time convenient to you and, if possible, for the record, what your estimates are on the balance of payments for the fiscal year ending June 30, 1964, and to include with that an itemized list of the factors which go into the total.

Secretary DILLON. We can try to do this, but it will necessarily be a rough estimate.

Senator DOUGLAS. I understand.

(The following table and statement was supplied for the record:)

U.S. balance of payments, fiscal year 1963 and 1st 3 quarters of fiscal year 1964 [1]

[In millions of dollars]

	Fiscal year 1963	July 1963–March 1964 seasonally adjusted annual rate	Change
Commercial merchandise exports	18,13[illegible]	20,8[illegible]	+2,713
Commercial merchandise imports	−16,251	−17,41[illegible]	−1,167
Commercial trade balance	1,888	3,43[illegible]	+1,546
Commercial services, remittances, pensions (net)	1,599	1,80[illegible]	+210
Commercial balance [2]	3,487	5,243	+1,756
Military expenditures (net) [3]	−2,284	−2,236	+48
Government grants and capital payments abroad	−1,059	−69[illegible]	+364
Government debt payments excluding fundings, prepayments	439	515	+76
Private capital:			
Transactions in foreign securities	−1,692	−289	+1,403
Other long-term [4]	−1,745	−2,267	−522
Short-term	−798	−1,146	−348
Errors and omissions	−982	−416	+566
Balance on regular transactions	−4,634	−1,291	+3,343
Special Government transactions [5]	1,831	872	−959
Overall balance	−2,803	−419	+2,384

[1] Excluding military transfers under grants.
[2] Excluding exports and services financed by Government grants and capital.
[3] Excluding advances on military exports.
[4] Including direct investment.
[5] Includes nonscheduled receipts on Government loans, advances on military exports, and sales of nonmarketable medium-term securities.

Source: Survey of Current Business and Department of Commerce.

SUPPLEMENTARY NOTE ON THE FISCAL 1964 BALANCE-OF-PAYMENTS DEFICIT

Data for the full final quarter of fiscal 1964 are not yet available, even in preliminary form. Because large flows of funds are usual during the midyear period, any projections for the full quarter on the basis of the earlier figures now at hand must be highly conjectural. It is clear, however, that the second quarter results will be substantially less favorable than during the January through March period, although the deficit on regular transactions for the year as a whole should be substantially less than half of that for the fiscal year ending June 30, 1963, and possibly less than $2 billion.

The primary factor accounting for the larger deficit during the second quarter was a reversal during April of a large inflow of short-term funds during March. This temporary swing appears to have reduced the deficit during the first quarter by roughly a quarter billion dollars, and added a similar amount to the deficit for the second quarter. This factor could account for a change of roughly $2 billion from quarter to quarter when converted to a seasonally adjusted annual rate. Purchases of foreign securities appear to have been somewhat greater in the second quarter. On the other hand, there are indications that the increase in bank lending abroad slowed. In addition the trade surplus in April was smaller than the first quarter average, and it is possible that this trend continued, although subsequent figures are not yet available.

Now, on the foreign securities which were sold in this country, were these exclusively bonds or did they also include stocks of industrial companies abroad?

Secretary DILLON. They also included stocks among the new issues and, of course, the bulk of the transactions in outstanding securities were in foreign stocks.

Senator DOUGLAS. Now, is a comparison between the earnings rates on foreign stocks and on American stocks really fair, for is it not true that American stocks tend to be overpriced and thus give a low yield?

Secretary DILLON. Well, it is difficult for me to say that American stocks are overpriced since their prices derive from millions of transactions in the open and free market. It is certainly clear that American stocks on an earnings basis are priced considerably higher than European stocks and their yields are considerably lower.

I think an argument can be made that there is at least some connection, we think there is a pretty close connection, between the general level of interest rates and this fact. The fact that long-term interest rates are generally higher in Europe means that the return on stocks generally has to be higher to make them attractive.

I think there is some connection in that way. German stocks, for instance, sell 13 or 14 times earnings as against 18 or 19 times earnings for American stocks.

Senator DOUGLAS. Is that the present average?

Secretary DILLON. I think something of that nature, yes.

Senator DOUGLAS. Well, may not this low earnings ratio in the United States be due to a greater degree of speculation rather than to lower rates of actual earnings upon physical investment?

Secretary DILLON. Well, in view of the volume of transactions on the New York Stock Exchange—and we can also assume the volume of speculative transactions can be measured at least by those that are on margin—although there may be some outright speculation, it would seem this is a relatively small part of the total.

I think one of the reasons why American stocks sell at a high price is that pension funds and certain organizations of that type—also mutual funds who sell their new securities all over the country—have, over the last decade, been bringing into the market rather substantial

Approved For Release 2005/05/18 : CIA-RDP66B00403R000500200001-2

amounts of money, and the supply of new stocks in the form of new issues has not grown as rapidly as this demand from very solid sources.

So, I think it is probably a question of supply and demand; there has been a bigger demand than supply.

Senator DOUGLAS. Mr. Dillon, you are probably too young to remember at firsthand the summer of 1929.

Secretary DILLON. I remember it.

Senator DOUGLAS. You remember it?

Do you remember that we were told then that we were in a new economic era, in which interest rates were falling, as evidenced by the very high ratio of stock prices to earnings. We were told that this was an indication since the yield on stocks in terms of their prices was low this was an indication that interest rates were down in this country, and that this was, therefore, to be heralded as a very good thing.

Do you remember that?

Secretary DILLON. I remember that episode and I also remember there was a very substantial number of stocks that were on margin at that time. We didn't have, of course, the controls and the Securities Exchange Commission and that sort of thing. As I recall there were times during that year when call money—1 day call money in New York borrowed to purchase stocks on margin—was as high as 10 and 12 percent. It was because of this very large speculation.

Of course, there is speculation today. The big difference now is that the great bulk of our securities, a much larger amount, are owned in solid hands such as, as I was saying, pension funds, trust accounts, and mutual companies that do not owe money and are not likely to sell them.

That doesn't mean the stock market can't go down rapidly, as we saw in 1962, just 2 years ago, but it is not the same. It doesn't get the same kind of self-increasing momentum.

Senator DOUGLAS. What I am trying to suggest is the possibility that the lower rates of return in the United States on industrial securities as compared with those on the Continent of Europe may be due to a greater degree of speculation permeating the American securities market and the American stock market relative to that present in Europe. May not the disparity in yields be distorted by this fact?

Secretary DILLON. I think that could be.

We haven't made any study of the amount of speculation in the European markets. I don't know what that situation is.

Senator DOUGLAS. There is one statement of yours which pleased me very much and which I am sure will please my colleague, the Senator from Tennessee.

You took a noble attitude in saying that you were opposed to driving up the long-term structure of interest rates by 1 percent because it would work against—

all that we are trying to achieve to reduce excessive unemployment and encourage the investment that creates jobs and promotes efficiency.

Is that a permanent pledge on the part of the Treasury?

Secretary DILLON. It has been our view right along, and certainly I should think would continue to be, that it would be highly unsound

by artificial means—which means a very drastic restriction of credit—to try to increase the long-term rates of interest at which we finance something approaching $50 billion of new investment in the United States, including mortgages, State and local authorities and corporations, every year merely to have an effect on $1 or $2 billion of foreign investment.

Senator DOUGLAS. Mr. Secretary, it is impossible for mere Members of Congress to penetrate the mystic recesses of Federal Reserve and Treasury policy on this matter, or to make out what the policy is from the somewhat Delphic utterances of the Treasury and the Chairman of the Federal Reserve. Whisperings have been heard about Washington, however, that it was the real inner design of the Treasury and the Federal Reserve, in conformity with pressures exerted by European banks, to raise domestic interest rates.

Do you deny this?

Secretary DILLON. I never heard of it.

Senator DOUGLAS. Well, you should move in different circles.

Secretary DILLON. I read it in the press. I read it in the press——

[Laughter.]

Secretary DILLON (continuing). But I have never heard of it in the Treasury or Federal Reserve System.

Senator DOUGLAS. Do you disavow this as a purpose of the Treasury?

Secretary DILLON. Certainly.

Senator DOUGLAS. You do.

Well, this is very encouraging, it is very encouraging. I hope you persist in this virtuous attitude.

Secretary DILLON. I think the record of the past 3 years illustrates this. Long-term interest rates have not moved much at all. On the whole, they are just about the same as they were 3 years ago, in some cases they are lower.

Mortgage rates are half a percent lower than they were 3 years ago.

Senator DOUGLAS. Haven't you been under great pressure from the European bankers to raise domestic interest rates?

Secretary DILLON. No. We had to raise short-term rates from the point of view of short-term outflows, but they have been pretty well in balance or reasonably well in balance for the last year. We haven't had the same pressure regarding our long-term rates at all.

Senator DOUGLAS. That is very encouraging.

Secretary DILLON. I think many of the Europeans, if I may say a little more on that, realize themselves that their long-term rates are on the high side, compared to anything in past history. They are way on the high side and should eventually, if they are going to conform to the past, come down. I think this is due to the fact that their markets, capital markets, are inadequately developed. They are trying to improve them. They all recognize this is necessary, and I think there is a general feeling that it is a very difficult job to do and they don't know when it will be done but that, probably over a long period of time, longer term interest rates should come closer together, and the way should be more by a reduction in high European rates than by an increase in ours.

That certainly was the view of the man I used to respect a good deal in this area who is the former Chairman of the International Monetary Fund, Mr. Jacobsson, who always felt our long-term rates were about right and that the European rates should come down.

Senator DOUGLAS. Good.

Now, you speak of the exemption for new Canadian issues. This is not in the act, is it?

Secretary DILLON. It is in the act in the general form described earlier in my statement. The President has the right to provide an exemption in the case of new issues from a particular country where actions taken by that country as a result of the tax would threaten the monetary stability of the whole international monetary system, not just the one country.

Senator DOUGLAS. But you think that this exemption actually will have exclusive reference to Canada?

Secretary DILLON. Canada is the only country that meets that qualification.

Senator DOUGLAS. Have you given administrative assurances to Canada that they will be granted this exemption?

Secretary DILLON. We told the Canadians that last summer when we asked for it that, if Congress enacted it, they would be granted it.

However, we have also pointed out as a very important part of that exemption that the President has the right at any time should their exemption be abused—should total outflow of money or total sale of new issues in the United States from Canada grow and be too large—to limit it or to revoke it entirely. We have told them very plainly, and I repeat it here, that we would be fully prepared to use that authority should they not be able for one reason or another to live up to their commitment which was to take monetary action in Canada of a kind that would keep their demands on our market within the range of their needs for international reserves without adding to their reserves.

Senator DOUGLAS. This was in response to the very heated protests of Canada that the interest equalization tax would make their problems more difficult?

Secretary DILLON. It wasn't so much a question of protests. It was a question of what happened in Canada when this tax was announced. There was a psychological reaction there which we have always felt was larger than the facts warranted but there was no doubt of the reaction. In the financial field, psychology can create facts—it had here—and there was a real panic on the Canadian markets. There was no doubt that, if this exemption had not been promptly granted, the Canadian dollar, which had only recently had a firm par value established, would have been devalued once more and that would have been very bad for the whole international monetary system including our own interests.

Senator DOUGLAS. Only a few months before had not the Finance Minister of Canada proposed tax measures which would have reduced the volume of American investments in Canada?

Secretary DILLON. I think that was his objective, but his proposals have been modified since then.

Senator DOUGLAS. In other words, Canada wanted to reduce the amount of American investment in Canada; yet when we took a step

that might work toward that end Canada could not face what would happen to it if we did reduce our investment. Is that true?

Secretary DILLON. I think that is true, yes.

Senator DOUGLAS. Immediately following our pledge that Canada would be exempted from this tax, did not Canada then announce that she would tax the importation of American automobile parts and that any revenues thus collected would be used as a bonus to stimulate the export of Canadian automobiles into the American market?

Secretary DILLON. That wasn't announced immediately. It was some 3 or 4 months afterward, and it was part of a program, apparently, that the present Canadian Government had in mind prior to their election.

We think that there is a serious question whether or not it is in contravention of our countervailing duty laws, so that the Bureau of Customs has undertaken a formal investigation. Complaints are now being formally received and I think there is a 30-day period, and Customs has given a 15-day extension to some people who wanted to submit more information, so all the information should be in about the middle of July and we can have a ruling on it.

Senator DOUGLAS. I feel very friendly toward our neighbor to the north but couldn't you say this was an action on Canada's part of returning evil for good?

Secretary DILLON. Well, the Canadian idea in this area—they don't feel that.

Senator DOUGLAS. No, of course not, but what you say——

Secretary DILLON. They look at it as a desire to balance their trade, their current account, more fully in the world so she won't need to have this very substantial capital inflow which has been taking place over the last 10 to 15 years, which has been what has balanced their accounts.

Senator DOUGLAS. At least it is not an indication of hemispherical solidarity on the part of Canada; isn't that true?

Secretary DILLON. I think they would not agree that it was directed against it but certainly it was against our policies. There was a difference of opinion.

Senator DOUGLAS. In other words, we made a concession to them, in exempting them from the interest equalization tax, and shortly afterward they replied by discouraging our exports of automobile parts to them and encouraging their export of automobiles to us.

Secretary DILLON. I think that is a simplified way of putting it or looking at it.

Senator DOUGLAS. Isn't that substantially true?

Secretary DILLON. Well, you say concession to them. It was a concession to them, but it also was certainly in our own interests. It is very important that we maintain general stability in the international monetary system and to have a country as important as Canada devalue its currency could have had all sorts of repercussions, including repercussions against the dollar.

Senator DOUGLAS. And this was accompanied at the same time by Canada's sale of food, specifically wheat to Cuba, and Canada's trading with Cuba against the national policy of the United States.

Secretary DILLON. Well, they have in some ways cooperated quite well. They sell no strategic items. They don't sell any parts to Cuba that are bought from the United States. They don't try to replace

that trade, but they have sold food and things of that nature, and they did sell some wheat.

Of course, they have a different idea regarding trade. They sell wheat to Communist China which we don't.

Senator DOUGLAS. Mr. Dillon, I want to say I think you have carried out the injunction of the Bible to walk the second mile, and to turn the other cheek. I believe in this up to a limited degree. I don't think it can be carried on forever, and I wish our friends to the north would recognize that we have been tried, really, almost to the bounds of ordinary patience in accommodating them.

I want to commend you for your self-restraint, and only hope that the bread which is cast upon the waters may sometime return.

You join me in that wish?

Secretary DILLON. That is fine, yes.

[Laughter.]

Senator DOUGLAS. One final question and then I will stop.

American banks can still make long-term loans to industrial enterprises abroad even though this does not involve the purchase of securities, is that right?

Secretary DILLON. Yes, if that is in the ordinary course of their business they can do so.

Senator DOUGLAS. Now, this provides an opportunity to evade or to avoid the interest equalization tax, isn't that true?

Secretary DILLON. That was a possibility, and there was a good deal of concern and discussion about that when we were considering this bill in the House.

We did not feel that the banks would avail themselves of that opportunity because they have limitations on the amount of foreign loans they can make, particularly longer term ones. But as a result of this discussion, we suggested, and the House accepted and put into the bill, a provision for reporting in detail on all foreign bank loans, and we asked the banks to commence that reporting without legal obligation, on a voluntary basis beginning the first of this year. They have complied very well with that, and we have gotten very complete reports up through the first 5 months of the year. In analyzing those reports, which we have done carefully, we can't see that there is anything in the way of any significant avoidance taking place.

Bank loans have been rather high—at least through the first quarter they were increasing rather rapidly. The increase apparently is rather less, and the total may even decrease during this second quarter—this present quarter. But if there is any evasion in that area, it can't be more than about 5 percent of the total bank loans. It is a very small amount.

Senator DOUGLAS. Do you have any estimates as to what occurred before you required reporting?

Secretary DILLON. I would think about the same thing. There was one specific loan we knew about in August that was rather large, that may have changed the picture a little bit. It was a $20 million borrowing, which I think was nearly ready to be done in the public market, but didn't quite get under the effective date, and that was converted into a bank loan. But that was the only specific case that I know of.

Senator DOUGLAS. Thank you very much.

I am going to ask Senator Smathers to take over.

Senator SMATHERS (presiding). Senator Williams, do you have some questions?

Senator Gore?

Senator GORE. Mr. Secretary, the overall problem of outflow of capital and outflow of jobs, which has been a very severe one, is a subject on which I had extensive conversations with the late President Kennedy both before and after his inauguration.

It is a subject upon which, as you know, he had and he held very strong convictions.

This problem, as I recall from our conversations, was one which he thought could and should be approached—I will not attempt to say what he thought; my recollection might not be entirely accurate.

At least it was my view that it should be approached both from a standpoint of tax policy and through direct regulation of outflow.

I thought his recommendation, in which you concurred, with respect to the taxation of direct investment and the return on that investment—the bearing this would have upon repatriation of earnings—was quite far reaching and commendable.

I helped as best I could to bring that proposal into legislative enactment and I resisted the nibbling away process.

Unfortunately, the original administration recommendation suffered from considerable nibbling.

I wish to commend the administration upon this current proposal. As far as it goes, it is good. I shall help you secure its passage.

But, two things disturb me. First, the nibbling away process with respect to this bill is led by the Treasury itself. This is not to say that all of your proposed amendments are in that category, but a great many of them are.

Instead of leading the way toward weakening your proposal, it seems to me that it should be strengthened by positive Treasury recommendations.

The second thing that disturbs me is what appears to be your abhorrence of, and reluctance to use, the power within the Government to regulate capital outflow if that regulation is needed. In your statement you set up a good, not a strong, strawman—a rather fragile one, really, and that is a political tactic not unknown to a Senator.

Rather than ask you a whole series of questions, and taking the time of the committee to make these points, I thought I would briefly state them and I now solicit your response.

Secretary DILLON. Thank you, Senator, I appreciate it, and I appreciate your offer of support in this bill which I think is most important.

Our feeling on the first point you made about our amendments has been that we have maintained very strongly, after quite extensive discussion and argument in the Ways and Means Committee in the House, since that time—and we do maintain now—the principles with which we originally started which were that this should apply to all portfolio transactions of new securities or securities which are new or outstanding.

There have been all sorts of attempts to get us to modify our point of view in one way or another on that, either by exempting stocks or by exempting outstanding issues or by allowing various switching privileges, things of that nature. We have not agreed to a single one of those.

We believe, however, it is important to be very careful and not bring into the ambit of the tax things that we didn't mean to cover in the first place, and that is largely what these particular amendments have to do with. This is true with the amendments in the export field, the operations of insurance companies abroad, things of that nature which were essentially technical, and which we do not think will have any balance-of-payments effect.

But I want to assure you that we will resist here, as we did in the House, any change which affects any of these basic fundamentals.

As to the second question, which is the question of capital control, we have felt that this interest equalization tax was the fairest and best way to operate because we see lots of problems with capital controls, a capital issues committee, as we have pointed out.

Nevertheless, there has been a lot of discussion about this in the time since this tax was originally suggested. Certainly I don't mean to imply that if this approach should turn out, as some fear, not to work, and we should need to take further action sometime in the future, that a capital issues committee wouldn't be a proper way to approach the problem, even though it does have difficulties.

But I want to make our position very clear about one thing. There has been a lot of rather nebulous talk about the capital issues committee on the assumption that it would be a voluntary arrangement.

We have looked into that and we are convinced it will not work. Wherever there are capital controls abroad it is the Government that has to make the final decision. That is the only way it would work, and it is the only way it would work here. So we do not feel that any sort of voluntary control mechanism asking investment bankers to control themselves would be able to work, even though they had a desire to make it work.

So, it would have to be a Government control arrangement, and we just felt, because of that, we would not start off with it.

We think the interest equalization tax approach will work and do the job that is needed. It certainly has thus far.

If it doesn't after its actual enactment, assuming enactment sometime in the future, as I do, and we then feel a capital control committee run by the Government, is necessary, I think it should be undertaken.

Senator GORE. Well, that is an encouraging statement. One of the principal exceptions that I would take to the statement you have just made is that since it may become necessary for the Government, for its own protection, to have and to exercise regulatory authority, it seems to me that the course of prudence would be to enact a measure providing for standby regulatory procedures.

I agree fully that the measure which you now recommend, which is already actually in effect, has had beneficial results, but it is at best a halfway measure; and if all the amendments which you have proposed are adopted it will be less effective than it has already been. And I have some concern about the possibility of even further weakening amendments being adopted.

So, you and I are in substantial agreement except that I think it would be prudent and wise to enact standby authority now, while you seem to be reluctant in that regard.

Secretary DILLON. We haven't felt the Capital Issues Committee was necessary. I would say we are reluctant since we hope it would not be necessary to use it, and we would not want to give the appearance we are asking for it.

However, if the Finance Committee in its wisdom decided it was a good thing to have as a standby measure in addition to the present provisions of the bill, I don't think Treasury could very well have any objection to that.

Senator GORE. Thank you very much.

Thank you.

Senator SMATHERS. Senator Williams.

Senator WILLIAMS. I am going to yield to Senator Dirksen.

Senator DIRKSEN. I will yield to Senator Bennett.

Senator BENNETT. Mr. Secretary, I have had many, many questions about this bill and about this action since the day it was proposed, and as the year has gone on my doubts have increased rather than decreased, so if I ask some of these questions now, I hope you will feel I am not trying to embarrass you but just trying to get at the facts.

When you were talking with Senator Douglas you were talking about the result of the effects of the announcement on the Canadian markets. I have heard that the Canadian, the value of the Canadian market, shrank a quarter of a billion dollars within 24 hours after this announcement was made; is that a pretty good estimate?

Secretary DILLON. I haven't made such an estimate, but I couldn't take any exception to it because there was real panic in the Canadian markets in the 24 hours following announcement of the proposed tax.

Senator BENNETT. How soon after that did you announce the exemption for Canada?

Secretary DILLON. As I recall, the President's message was on a Thursday, and the Canadian markets had their problems on a Friday. We made the announcement of the exemption over the weekend when the markets were closed, so it was made prior to the reopening on Monday. We were convinced, and I think it was true, that if there has been no such action it would have been necessary to devalue the Canadian dollar on Monday.

Senator BENNETT. Were there similar reactions on other world markets?

Secretary DILLON. No, not similar. There were reactions in all the markets to some minor extent, particularly in Europe, but these were overcome very shortly.

In Japan the reaction was a little greater although after a period of time that subsided, too. The Japanese were considerably concerned about this, but again history has shown that they have been able to get along all right so far, and we felt that in their case the tax really would not hurt their operations since their interest rates at home were so high that they could still borrow in this country and pay the tax, and get money at a far cheaper rate than was available in Japan, and we think they would.

Senator BENNETT. The Japanese asked for an exception and it was rejected.

Secretary DILLON. That is right.

Senator BENNETT. Is my memory correct?

Secretary DILLON. That is correct.

Senator BENNETT. Do you have any knowledge to the extent to which there is a backlog of need in Japan for foreign capital which is still stacked up hoping that this bill will not pass?

Secretary DILLON. I don't think it is as large by any means as the Japanese expected it would be because they have had much greater success in selling their issues in Europe than they thought they would last year.

This is one of the good things that has happened and one of the things we hoped would happen is that European capital markets would become more active and carry a larger share of the burden.

During the first half of this year the indications are that the Europeans will have taken foreign issues at an annual rate of twice the volume that they have been taking before; and Japan has had a very large share of that. So they are I think, in a reasonably good posture. I still think that the Japanese will come into the U.S. market after the tax is passed and pay the tax, and we hope they do, because we think they need some long-term capital and we should supply it but in reasonable amounts.

Senator BENNETT. But they haven't been coming in and trading on the assumption that the tax was going to be applied.

Secretary DILLON. No, they have not made any issues on that basis.

Senator BENNETT. I have just been handed a copy of the Japan Stock Journal of June 22, and this is apparently the lead editorial, this is June 22 of this year.

> Almost a year has passed since July 9, 1963, a day that has gone down in Japanese stock market history as black Friday. It was on that day, after the late President Kennedy announced his proposal for the correction of an interest equalization tax on American purchases of foreign securities that the Dow-Jones Index for the first section market of the Tokyo Stock Exchange plunged 64.41 points from the previous day's closing level to 1,449.90. It was the biggest absolute decline ever recorded in a single day's trading on the Tokyo Stock Exchange.

So it had a very substantial effect in Japan as well.

Do you think, Mr. Secretary, that it was this, the proposal of this interest equalization tax that this is the chief reason or maybe the only reason, there was a falling off of sales of foreign securities in the United States particularly from Western Europe.

Secretary DILLON. Oh, yes, sir; I very much do, and from Japan.

Senator BENNETT. I am leaving Japan out of my question because in the last year we have seen situations arise in Western Europe that in my opinion would suggest to a prudent American investor that that wasn't the place to put his money. We have seen the situation in Italy, we have seen De Gaulle and his actions in France, and we see the prospect now of a return to power in Britain of a labor government talking again about the nationalization of some parts of industry.

Don't you think those were psychological factors that had some effect on the scene?

Secretary DILLON. I would like to modify my reply.

I don't think such factors had any effect on the overall volume of new issues, largely debt issues, coming from Europe, that would have been sold in this country, but I do think that they did have an effect on the desire of Americans to continue holding European stocks, and I think that they, in combination with its tax—and it's impossible

to weigh the relative weight of each—led to the very remarkable turnabout in trading in outstanding securities from an annual outflow of about $250 million at an annual rate inflow of about the same amount. So it resulted in a benefit to our payments of over $500 million on outstanding issues, largely with Europe.

Senator BENNETT. Well, there would have been a partial effect then in view of the changes that had occurred.

Secretary DILLON. A partial effect on the purchase of stocks, I think that is very right. Certainly the tax, as such, provides no reason for an American to decide he wanted to sell a European stock. It might prevent him from buying a new one but our actual American sales or liquidations of European stock which had been bought earlier did increase and so that must have been for some other reason, and I think it was for the general reasons that you have outlined.

Also you have got to add to that—and I think equally important is the fact that—inflationary pressures and sharp increase in costs in Europe over the past few years have substantially narrowed the profit margins of European industries. European stocks themselves were no longer as attractive relative to American stocks as they had been before, even in the absence of these political considerations.

Senator BENNETT. So these were considerations that were working on the problem outside of the effect of this particular bill?

Secretary DILLON. Yes, that is on outstanding stocks.

Senator BENNETT. Has any study been made of the capacity of the European markets to supply their own needs, plus those of Japan since we have put this barrier in their way.

Secretary DILLON. The Treasury made, at the request of the Joint Economic Committee, a very detailed study of a number of European markets to point out problems that existed in each one of them and how they operated. That has been submitted and printed, and I think is generally looked upon as the most comprehensive statement of the problem that has ever been made, either in the United States or abroad. It does not make an estimate of what can be done and that is very difficult to do in the absence of much more effort.

However, I can point to what has happened. I think that is the only interesting thing to look at. In the first half of 1964, there were foreign issues sold in the European market amounting to about $600 million. Now, in the first half of 1963 there were only about $200 million, and in the whole year 1963 there were about $480 million.

The whole year 1961 which was the previous high point, there were also $480 million and in other years there were under $300 million, why I say it doubled, and that is a very gratifying development.

It shows that the European capital markets can carry a greater share of the load. I think that will increase, too. For instance, in Germany they have now introduced a law that will be helpful. They have had a 2½ percent tax on the principal of any new bond issue sold. After a good deal of study and problems—it was a difficult tax to repeal because the proceeds of the tax were given to the states; it didn't go to the Federal Government—they have now reached agreement on trying to repeal it and a bill is in the Bundestag and the general impression is that it will be repealed in the next few months. That will improve those markets because it will reduce the cost of getting capital in Germany.

Senator BENNETT. On the 25th of June, the New York Times had an editorial which has one sentence in it that I think is very interesting. It says:

> Yet, as we have previously pointed out, the proposed interest equalization tax is an effective control only in its present uncertain form.

It raises the interesting question, isn't it a more effective control if if it is a threat than it would be if it were enacted into law?

Secretary DILLON. That is an interesting question, and up to a point, I would say the answer is "yes." As far as outstanding securities are concerned there should be no difference, because trading in them has been proceeding on the same basis as if the tax were law. Any trading in outstandings that was done was done with the idea they would have to pay the tax.

However, for new issues I think that it was somewhat more effective, certainly in the latter part of last year, for instance, because there were practically no new Canadian issues. In the first quarter of this year, and again the second quarter, the Canadians, apparently relying on the hope that this exemption—the authority to the President—would be included in the bill, have reentered our market and there have been some new Canadian issues, so to that extent I think the situation will not change too much after the tax is enacted.

Certainly in the case of Japan, there is a big difference because the Japanese have not been in our market at all, and I am sure that once the tax is enacted—and they know it is necessary to pay it—a number of Japanese issues will come to this market whereas they have been operating under the hope that it might not come into effect.

So, as I mentioned in my statement, the effect in the first 9 months has been somewhat exaggerated by the uncertainties as to whether the bill would actually become law or not.

We do expect that, if the tax becomes law, there will be a greater volume of transactions but still within the total that we think is proper, and we think that is fine because we don't have any desire or intent to put the New York market entirely out of business. Many of our bankers have gone to Europe, and are now taking part in offerings in Europe, which is a good thing. But they also should have business and will have business in New York once the tax is passed.

Senator BENNETT. Well, you have said to the committee in your statement in effect that the proposal of the tax has had a very definite beneficial effect on our balance of payments.

Now, we write the tax into law and we do two things: It becomes rigid. Men operating out of the European markets can begin to look for the ways by which they can get around its provisions, and apparently you see the existence of such possibilities because you have sent up to the committee a list of proposed amendments which have come to us so late that we haven't had a chance to know what they are.

The statement is that they are technical, and when you talk about technical amendments you are talking about means of closing "loopholes."

Secretary DILLON. These are generally the other way.

Senator BENNETT. They open, they are liberalizing them.

Secretary DILLON. Generally, because they generally affect very particular situations that we only learned of after the bill had passed the House or during consideration by the House after the Ways and

Means Committee had finished with the bill and it was too late to make any changes. There were cases where certain transactions which were not intended to be caught under the tax were caught under it, and these changes make clear they were not meant to be. That is what the great bulk of them are.

Senator BENNETT. Is it your intention before we get through to have someone explain these exemptions to us?

Secretary DILLON. Yes. I think they are less by far than the exemptions already in the bill. Many of them merely clarify existing exemptions of the bill as it came from the House. But we would be glad, to the extent you want an executive session or by some other means, to take them one by one, if that is what you are interested in.

It can be done very quickly. I think the first 4 or 5 pages of that committee print with a general description of the amendments, maybe it is the first 10 pages, gives a very clear picture of what they are.

Senator BENNETT. We are going to have witnesses who will follow you who probably should know what the Treasury is aiming at with these exemptions?

Secretary DILLON. That is why we sent those up on the 12th of June. They were printed so they could have a couple of weeks to look at them and study them and be able to comment on those particular amendments.

Senator BENNETT. One final area, Mr. Secretary, and then I have had more than my share, in the annual report of the bank for international settlements this statement appeared:

> However, a firm equilibrium has not yet been secured and hence efforts to achieve it cannot be relaxed. The immediate need is to decrease the Government expenditures abroad which was announced in last July's program.

To what extent have we succeeded in these last 12 months in carrying out that objective?

Secretary DILLON. Well, I have been following that regularly and carefully, and I am convinced that it will be met on time.

The greater portion of that planned reduction was in reduced military expenditures, and those are all scheduled. They are largely redeployment of support troops and closing various installations abroad, some of which have already taken place and others of which are definitely scheduled. The orders have been issued and they will be taking place over the next 6 months.

When we get to the end of the year, they will all be in effect, and my feeling is that we will meet that billion dollar total.

Senator BENNETT. When you say the end of the year you are talking about the end of the calendar year of 1964?

Secretary DILLON. The July statement was that we would be running at a rate of expenditures abroad, beginning the first of January 1965, of a billion dollars less than we were running in 1962.

Senator BENNETT. Under those circumstances if this bill were to be passed why shouldn't it terminate January 1, 1965, and throw the burden back on the public sector where it belongs rather than expect the private sector to carry it for an additional 12 months?

Secretary DILLON. Well, that billion dollars isn't enough. We have to do other things. We have to improve our exports, which are improving. We have to, by means of better business here and less attractive opportunities in Europe, improve our balance on direct investment. I think that is improving.

But as I said at the end of my statement, all this takes time, and we felt that the first time that would be prudent for ending this tax was after we had a full year at this lower rate of Government expenditure and that little extra time for our own economy to move in ways that will help our balance of payments.

We think that that is only prudent. It would not be prudent to end it so rapidly as the end of this year.

Senator BENNETT. Do you have any worries about the constitutionality of a proposal which is at least 1 full year retroactive?

Secretary DILLON. No. We have looked into that very carefully. There have been a series of court opinions, including Supreme Court opinions, and there is no doubt about the authority to levy a retroactive excise tax as long as the period of retroactivity is reasonable. Generally the Court has found that the entire year preceding the year in which the tax is enacted is reasonable.

We have two opinions by General Counsel of the Treasury Department, which I would be glad to furnish for the record. I think they should be in the record. They deal with that subject, and I think they would be helpful. If I may, I would like to offer them for the record.

Senator SMATHERS. Without objection, they will be part of the record.

(The opinions referred to follow:)

[Opinion file No. 765]

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., May 22, 1964.

To: Secretary Dillon.
From: G. d'Andelot Belin.
Subject: Validity of the effective date provision in H.R. 8000.

Section 2(c) of H.R. 8000 provides that the interest equalization tax amendments to the Internal Revenue Code shall apply, except for designated exclusions, "with respect to acquisitions of stock and debt obligations made after July 18, 1963." H.R. 8000 passed the House on March 5, 1964. If its enactment is completed in the latter half of 1964 its period of retroactivity will be approximately a year and possibly a few months more. The question is whether such retroactivity would be held to be unreasonably long and therefore a violation of the fifth amendment.

This memorandum is directed solely to the time factor in those Federal and State court cases in which the retroactivity of tax legislation has been held valid or invalid. I assume the recognition of the established principle of law covered in my Opinion No. 759 of August 6, 1963, that a tax law may be retroactive to a reasonable extent, that its reasonableness depends on the circumstances involved, and that among these circumstances an important factor is the extent of notice to the taxpayer. See *Milliken* v. *United States*, 283 U.S. 15 (1931); *Welch* v. *Henry*, 305 U.S. 134 (1938), and *United States* v. *Manufacturers National Bank*, 363 U.S. 194 (1960). The important element of notice to the taxpayer was provided with respect to the interest equalization tax in the President's message on the balance of payments sent to the Congress on July 18, 1963, and in the notice on the effective date of H.R. 8000 promulgated in the Federal Register of August 16, 1963, 28 F.R. 8426.

Concerning the reasonableness of the period of retroactivity there is a significant body of law holding that a tax act may constitutionally be applied at least to events occuring in the year preceding the year of its enactment. This memorandum will discuss first those cases which support this principle, noting that the principle extends at least to the 2 preceding years of a biennial legislature. It will then discuss those cases upholding retroactivity within lesser periods and, finally, those cases which consider certain long-extended periods of retroactivity to be unreasonable.

I. PERIODS OF RETROACTIVITY HELD REASONABLE

Title X of the Revenue Act of 1918 which was enacted February 24, 1919 (40 Stat. 1057, 1126), provided that "on and after July 1, 1918" every domestic corporation should pay annually "a special excise tax" with respect to carrying on business based on the value of its capital stock for the preceding year ending June 30. The retroactive provision of this law was upheld in *Hecht* v. *Malley*, 265 U.S. 144 (1924).

Section 404 of the Revenue Act of October 21, 1942 (56 Stat. 798, 944) provided that there should be included in the gross estate of a subsequent decedent for estate tax purposes that proportion of life insurance received by beneficiaries which was purchased with premiums paid directly or indirectly by the decedent although the decedent possessed no incidence of ownership in the policies. The retroactive feature of this amendment of the prior law relating to life insurance proceeds was the provision (at 945) that in determining the proportion of the premiums paid directly or indirectly by the decedent the amount paid on or before January 10, 1941, should be excluded if after that date the decedent possessed no incident of ownership. In *United States* v. *Manufacturers National Bank* (363 U.S. 194 (1960)) the Supreme Court determined that the amendment could validly relate back to the premiums paid in the 1 year and 9 months between January 10, 1941, the date specified in the statute, and October 21, 1942, the date of the enactment of the statute. The date specified in the statute was the effective date of a Treasury regulation (T.D. 5032, 1941–1 Cum. Bull. 427) which had provided for such proportionate inclusion of life insurance proceeds from previously divested policies. The Supreme Court said that the existence of this regulation gave "fair notice" of the likelihood of the tax consequences and thus contributed to the validity of the statute which enacted the substance of the regulation.

The *Manufacturers National Bank* case is, thus, a recent assurance that legislation is valid which attaches tax consequences to transactions occurring after the date of a promulgation of the probable tax consequences by the executive branch if Congress adopts that date in a statute enacted within a reasonable time thereafter, and that a reasonable time at least includes the year following the year of the executive action.

The 81st Congress in its 2d session and the 82d Congress in its 1st session provided for excess profits taxation in the acts of January 3, 1951 (64 Stat. 1137), and October 20, 1951 (65 Stat. 452, 562), which were to be applied to all taxable years ending after June 30, 1950. The reasonableness of this legislation was upheld as established law in *Neill* v. *Phinney* (245 F. 2d 645 (5th Cir. 1957)). Some warning of this retroactivity had been given taxpayers by the provision in the act of September 23, 1950 (64 Stat. 906, 967), which directed the House Committee on Ways and Means and the Senate Finance Committee to report a bill for corporate excess profits taxes with retroactive effect to October 1 or July 1, 1950.

In this discussion belongs the landmark case of *Welch* v. *Henry* (305 U.S. 134 (1938)), which became the precursor of a number of State cases upholding tax legislation retroactive to the preceding legislative year. This case involved the validity under the due process clause of the 14th amendment of a law enacted by the Legislature of Wisconsin in 1935 taxing previously untaxed dividends received by the taxpayer in 1933. The State supreme court in upholding this tax observed that a legislature may measure a tax by the income of a year sufficiently recent so that there was some relation to the ability of the taxpayer to pay the tax (*Welch* v. *Henry*, 223 Wis. 319, 271 N.W. 68 (1937), affirmed on reconsideration 226 Wis. 595, 277 N.W. 183 (1938)). In the Supreme Court, Justice Stone observed that one criterion was whether the taxpayer could reasonably have anticipated the tax and this required consideration of the circumstances in each case (at 147). He concluded that while there was a period beyond which a taxing statute would be unconstitutional in its backward reach a legislature generally could tax prior but recent transactions, including transactions occurring in the 2 years preceding the next session of a biennial legislature.

This Supreme Court decision provided the rationale expressed by the New York Court of Appeals in permitting the application of the State utility tax law of 1941 to sales of electric current subsequent to January 1, 1940, while rejecting the application of the law to sales subsequent to May 1937 (*Lacidem Realty*

Corp. v. *Graves*, 288 N.Y. 354, 43 N.E. 2d 440 (1942)). The *Welch* v. *Henry* decision was also the basis for the holding in *National Can Corp.* v. *State Tax Commission* (220 Md. 418, 153 A. 2d 287 (1959), appeal dismissed, 361 U.S. 534 (1960)). The 1958 State statute there upheld had the effect of ratifying the practice of assessing real property differently from personal property subsequent to January 1, 1957. In *Land Holding Corp.* v. *Board of Finance and Revenue* (388 Pa. 61, 130 A. 2d 700 (1957)), the State supreme court upheld the application of an act of June 1, 1955, which applied the tax on the recording of deeds to documents executed outside the State which had been offered for recording during the 2 years after May 31, 1953. The court relied on *Shirks Motor Express Corp.* v. *Messner* (375 Pa. 450, 100 A. 2d 913 (1953)), discussed further below, which had followed *Welch* v. *Henry*.

Since tax legislation has been held retroactive to the first and even the second year prior to the year of enactment, it is not surprising that there are many Federal and State cases upholding tax legislation which was retroactive to the beginning of the year in which the act was passed, or to the first of some month within that year, or to some specific prior date within the year considered appropriate. Among the various Federal cases the earliest is *Flint* v. *Stone Tracy Co.* (220 U.S. 107 (1911)). Here the corporation excise tax imposed by the Tariff Act of August 5, 1909, was upheld although it was to be measured by the income of the business from the beginning of the year. Another early case was *Billings* v. *United States* (232 U.S. 261 (1914)), validating a Federal use tax imposed by an act passed in August 1909 on the use of a foreign yacht during the taxable year September 1, 1908, to September 1, 1909. The Supreme Court accepted as constitutional, without discussion, an act of September 8, 1916, retroactive to January 1, 1916, which imposed a Federal excise tax on the manufacture of munitions (*United States* v. *Anderson* (269 U.S. 422 (1926)).

Federal income taxes retroactive to the beginning of the year in which the tax was passed or to the first of a subsequent month were upheld in *Reinecke* v. *Smith* (189 U.S. 172 (1933)), *Cooper* v. *United States* (280 U.S. 409 (1930)), *Lynch* v. *Hornby* (247 U.S. 339 (1918)), and *Brushaber* v. *Union Pacific Co.* (240 U.S. 1 (1916)). This line of cases has been recently reaffirmed by two circuit courts which upheld the provision in the Revenue Act of September 23, 1950 (64 Stat. 906, 935), making distributions of gains from collapsible corporations distributed after December 31, 1949, taxable as ordinary income rather than as capital gains (*Sidney* v. *C.I.R.*, 273 F. 2d 928 (2d Cir. 1960); *Spangler* v. *C.I.R.*, 278 F. 2d 665 (4th Cir. 1960), certiorari denied, 364 U.S. 825 (1960)).

Particularly pertinent to the validity of the retroactive provisions in H.R. 8000 are the two Federal cases upholding legislation retroactive to specific dates not the beginning of a year or of a month but which were considered appropriate by Congress because of the legislative activity which surrounded the enactment of the tax law.

The first case was *United States* v. *Hudson* (299 U.S. 498 (1937)), which found reasonable a special income tax on the profits from the sale of silver which applied to such profits made within 35 days prior to the act. The reason for this retroactivity in the Silver Purchase Act of 1934 (48 Stat. 1177, 1178) was similar to that underlying the retroactive provision of H.R. 8000; namely, to prevent increased transactions in anticipation of the passage of the act. In the second case, *Gillmor* v. *Quinlivan* (143 F. Supp. 440 (N.D. Ohio 1956)), the court upheld the provision in the Revenue Act of October 20, 1951 (65 Stat. 452, 504), which made a change in the status of certain gains from capital gains to ordinary income applicable to gains from sales or exchanges after May 3, 1951, the date when the House Ways and Means Committee announced its tentative decision to make the amendment. If such an announcement could establish a reasonable date from which to commence tax liability, it seems certain that the more widespread announcement provided by a Presidential message, supplemented by a notice in the Federal Register, would be held reasonable notice to the taxpayer.

Among the State cases permitting tax laws to be retroactive to the first of the year are *Shirks Motor Express Corp.* v. *Messner* (375 Pa. 450, 100 A. 2d 913 (1953)), appeal dismissed and rehearing denied (347 U.S. 941, 970 (1954)), and *Garrett Freight Lines, Inc.* v. *State Tax Commission* (103 Utah 390, 135 P. 2d 523 (1943)). In the *Shirks* case the tax law amendment which eliminated previously allowed credits for local taxes and registration fees in computing excise taxes from January 1, 1951, was not enacted until December 27, 1951.

II. PERIODS OF RETROACTIVITY HELD UNREASONABLE

The *Welch* v. *Henry* yardstick has been used to determine certain periods of retroactivity to be unreasonable as well as those periods which are considered reasonable. In *Wheeler* v. *C.I.R.* (143 F. 2d 162 (9th Cir. 1944)) the court decided that the Revenue Act passed in 1940 could not reasonably be applied to a 1938 transaction. It commented that the act was not passed in the congressional session following the year of its application. The Supreme Court reversed on the ground that the IRS regulations existing at the time of the transaction validly made the transaction taxable without application of the 1940 act, *C.I.R.* v. *Wheeler* (324 U.S. 542 (1945)).

A significant State case is *Commonwealth* v. *Budd Co.* (379 Pa. 159, 108 A. 2d 563 (1954)), appeal dismissed, sub nom. *Pennsylvania* v. *Budd Co.* (349 U.S. 935 (1955)). Here the court refused to apply a 1947 corporation net income tax to income received in 1944. It held that following *Welch* v. *Henry* a tax may not bet retroactively applied beyond the year of the general legislative session immediately preceding that of the tax enactment. To like effect was the decision in the *Lacidem* case, above discussed, which invalidated so much of the period of retroactivity as exceeded the year preceding the year of enactment of the tax statute.

A comprehensive review of the cases on retroactivity was undertaken by the court in *Comptroller of the Treasury* v. *Glenn L. Martin Co.* (216 Md. 235, 140 A. 2d 288 (1958)), in passing on a 1957 statute amending the State sales and use tax laws to be effective as of July 1, 1947. Since the amendments would apply to the company's sales and use transactions from 3 to 6 years prior to the statute the court concluded that the retroactivity exceeded reasonable limits.

CONCLUSION

From the foregoing analysis there seems to be no doubt that a Federal income or excise tax act may be retroactive through the year in which the law is being enacted and at least through the preceding year as well, or to specific dates within these periods, if the Congress has expressly provided for such retroactivity. Extended retroactivity has been permitted in many instances even without the presence of notice to the persons who may be taxed. The reasonable retroactivity of a statute is increased where all possible advance notice to prospective taxpayers has been given.

Consequently, it is my opinion that if the Interest Equalization Tax Act is passed at any time in 1964 its retroactivity to July 18, 1963, would be upheld and that no modification in the date of retroactivity is necessary to the act's validity. If enacted after 1964, the result would obviously depend upon the date of enactment and the circumstances, but such factors as the official notice and publication given to it, the passage of the bill by the House and continuing consideration in the Senate, and the widespread public anticipation of its enactment would all be relevant.

[Opinion file 759]

THE GENERAL COUNSEL OF THE TREASURY,
Washington, D.C., August 6, 1963.

To: Secretary Dillon.
From: G. d'Andelot Belin.
Subject: Constitutionality of the proposed Interest Equalization Tax Act.

You have asked my opinion on the constitutionality of the proposed "Interest Equalization Tax Act of 1963." This act would impose an ad valorem tax on the acquisition of certain debt obligations and securities of a foreign obligor or issuer not exempted from its provisions, would require the tax to be paid on certain acquisitions subsequent to July 18, 1963, the date of the President's message to Congress proposing this tax, and would require report and payment of the tax by the end of the first calendar quarter following the enactment of the tax act and at quarterly intervals thereafter.

I will deal first with the constitutionality of the proposed tax and secondly with the constitutionality of the proposed limited retroactive application of the tax. My conclusion from this analysis is that the proposed legislation would be constitutional.

I. Constitutionality of an ad valorem tax on the acquisition of foreign debt obligations and securities

I find no reason to doubt the constitutionality of an ad valorem tax on the acquisition of designated property, particularly foreign property. It has long been established that a tax on a property transaction is a tax on the exercise of one of the privileges of ownership of property and as such is an excise tax and not a direct tax requiring apportionment. *Thomas* v. *United States* ((1904) 192 U.S. 363). This case held that a stamp tax on the sale of shares of stock in corporations was an excise tax and not a direct tax on property. It concluded that excise taxes were those "imposed on importation, consumption, manufacture, and sale of certain commodities, privileges, particular business transactions, vocations, occupations and the like," (p. 370). The opinion cited several historic cases upholding as excises certain taxes on sales at stock exchanges, on agreements to sell stock and on the transmission of property from the dead to the living, illustrating property transfer taxes. See also *Fernandez* v. *Wiener* ((1945) 326 U.S. 340, 352).

It is immaterial that in the present proposal the tax would be paid by the purchaser rather than the vendor as taxes on the purchase of privileges or commodities are uniformly recognized as excise taxes The Federal tax on the purchase of a club membership was specifically held not to be a direct tax in *Congressional Country Club* v. *United States* ((1930) 44 F. 2d 266, 71 Ct. Cl. 161, cert. denied (1931) 283 U.S. 836) and *Munn* v. *Bowers* ((C.C.A. 2d 1931) 47 F. 2d 204, cert. denied (1931) 283 U.S. 845). Numerous State cases treating use taxes placed on purchasers as excise taxes will be discussed below in connection with the problem of retroactivity.

The express constitutional limitation on excise taxes is that they "shall be uniform throughout the United States" (art. I, sec. 8, ch. 1). This limitation requires geographic uniformity within the United States and does not prevent discrimination against foreign, as opposed to domestic, property interests. *Billings* v. *United States* ((1914) 232 U.S. 261). See also 26 U.S.C. 4371–4374 taxing the issuance of foreign insurance policies. The proposed tax would apply uniformly to all purchasers throughout the United States of the designated foreign obligations and securities and thus would meet the constitutional requirement. It is immaterial that the tax would apply to the acquisition of foreign obligations and securities issued in some countries and not in others. Differentiation between foreign countries has been included in tax legislation, most recently in section 955(c) of the 1954 Internal Revenue Code, as added by section 12(a) of the 1962 Revenue Act, 76 Stat. 1013.

There is no complication because the excise tax would take the form of an ad valorem tax on the acquisition of the foreign interests. Excise taxes are generally based on the value of the property sold or acquired. This is demonstrated in the various excise taxes on the retail sale of certain commodities, 26 U.S.C. 31, the sale and use of certain manufactured goods, 26 U.S.C. 32, and the acquisition and use of various facilities and service, 26 U.S.C. 33, to choose but a few examples.

A second constitutional limitation on the levying of a tax or duty should be briefly noted. This is the prohibition in article I, section 9, clause 5 that "No tax or duty shall be laid on articles exported from any State." The Supreme Court has interpreted this clause to mean that no tax can be laid directly on the export of articles; that is, commodities, merchandise, or goods in the act of exportation, or on shipping documents, necessarily accompanying such articles in export; that is, bills of lading or marine insurance on the articles. *Fairbank* v. *United States* (1901) 181 U.S. 283; *Thames and Mersey Insurance Co.* v. *United States* (1915) 237 U.S. 19. But it has refused to apply the limitation to taxation of activities and interests indirectly associated with the export of articles. Thus, income from exporting is taxable. *Peck & Co.* v. *Lowe* (1918) 247 U.S. 165. As shown by the tax applied since 1926 to the issuance of foreign insurance policies, this clause of the Constitution is not a restriction on the taxation of the acquisition of foreign intangible interests with the consequent outflow of monetary consideration from this country.

II. Limited retroactive application

The proposed tax would be applied to certain acquisitions made after the date of announcement of the legislative tax proposal by the President, July 18, 1963, but the tax would be paid at the time of filing the purchaser's first return before the end of the calendar quarter in which the act is passed. The constitutional question is whether this coverage of purchases of foreign obligations

and securities on and after the day following the President's message would violate the due process clause of the fifth amendment.

The retroactive application of a tax statute is not *ipso facto* violative of due process. The courts reviewing such statutes examine the particular features of the act, the legislative purpose, and the effect on the taxpayer to determine whether the act as applied to the taxpayer is so unreasonable and arbitrary as to constitute a taking of property without due process of law under the 5th or 14th amendment. By this process of analysis, the Supreme Court and circuit courts over a period of the last 50 years have upheld as consistent with due process the retroactive application of many tax statutes including, by way of example, the following:

1. The application of the first income tax act of October 3, 1913, to income received from March 1, 1913. *Brushaber* v. *Union Pacific Co.* (1916) 240 U.S. 1.
2. The application of a change made by the Revenue Act of 1921 in the cost basis of gift property in the hands of a donee to render taxable a "prior but recent" gain by a donee. *Cooper* v. *United States* (1930) 280 U.S. 409.
3. The application of a tax of 50 percent of the profits from the sale of silver bullion imposed by the Silver Purchase Act of 1934 to sales made within 35 days of the passage of the act. *United States* v. *Hudson* (1937) 299 U.S. 498.
4. The application of a 1935 State income tax to income received by the taxpayer in 1933 not previously taxed. *Welch* v. *Henry* (1938) 305 U.S. 134.
5. The application to gains from collapsible corporations distributed to stockholders early in 1950 of the change enacted in the Revenue Act of September 23, 1950, making such distributions subject to ordinary income rather than the capital gains taxation. *Sidney* v. *C.I.R.* (C.A. 2d 1960) 273 F. 2d 928; *Spangler* v. *C.I.R.* (C.A 4 1960) 278 F 2d 665, cert denied (1960) 364 U.S. 825.

The holdings in the foregoing cases were based on the reasoning that the Government's need for revenue could be satisfied by taxes on gains over a prior but recent period and that taxpayers receive gains with the knowledge that they are the legitimate subject of taxation. In the *Hudson* case the Supreme Court pointed to the legislative activity for some months prior to the enactment, thus suggesting constructive notice to the taxpayer of the likelihood of the taxation.

Retroactive excise taxes

Congress has also enacted excise taxes which have a retroactive reach in that the amount of the tax is measured by the business of the taxpayer for a period prior to the date of the enactment of the act. Thus in the historic case of *Flint* v. *Stone Tracy Co.* (1911) 220 U.S. 107 the Court upheld the corporation excise tax imposed by the Tariff Act of August 5, 1909, on capital stock corporations and associations which was measured by the income of the business from the beginning of the year. The Court considered the income from the beginning of the year to be an appropriate yardstick upon which an excise tax on the privilege of doing business could be based. Similarly, an excise tax on the privilege of doing business by a Massachusetts trust was held validly measured by the capital invested during a period prior to the application of the excise tax to such trusts. *Hecht* v. *Malley* (1924) 265 U.S. 144. The Supreme Court applied the munition manufacturers' excise tax of 12½ percent on the net profits received by the manufacturer during the preceding year without analysis of the constitutional question in *United States* v. *Anderson* (1926) 269 U.S. 422.

The Supreme Court did, however, more than three decades ago hold that the application of certain estate, inheritance, and gift taxes to transactions completed prior to the date of the act was arbitrary and unreasonable. Two of these cases involved the passing of property upon death. In *Nichols* v. *Coolidge* (1927) 274 U.S. 531 the Court rejected the application of an estate tax to trust property which the Court found had been completely transferred prior to the date of the estate tax act. In *Coolidge* v. *Long* (1931) 282 U.S. 582, involving the same estate, the Court found that the State inheritance tax could not be applied to the remainder interests in the trust. The authority of this case, however, is reduced if not eliminated by *Fernandez* v. *Wiener* (1945) 326 U.S. 340, *supra* (which expressly restricted it, at 357), and *United States* v. *Manufacturers National Bank* (1960) 363 U.S. 194. In these latter cases the Supreme Court held that the entire value of property transferred prior to the tax act may be subject to tax if any incidents of ownership or control over the property are transferred as a result of subsequent death.

The other two early cases involved the Federal gift tax act of June 2, 1924. In *Boldgett* v. *Holden* (1927) 275 U.S. 142 the Court majority, considered it unreasonable to apply the act to a gift made in January 1924. In *Untermyer* v.

Anderson (1928) 276 U.S. 440 the fact that the gift was made during the last stages of the enactment of the gift tax act did not move the Court majority to modify the *Blodgett* ruling. It should be noted, however, that (1) the four dissenting Justices in the *Blodgett* case thought that the gift tax act had not been intended to apply retroactively, indicating that Congress had not been explicit and definitive on that point; (2) the three dissenting Justices in the *Untermyer* case were Holmes, Brandeis, and Stone, whose dissents have often since become the law, and (3) these three Justices considered it reasonable to permit the recognized retroactivity of tax statutes to apply to Mr. Untermyer's gift. The *Untermyer* decision was to some extent modified in *Milliken* v. *United States* (1931) 283 U.S. 15 which held that a change in the rate of the gift tax could apply to a gift previously made as the donor knew that the gift was subject to tax and should have known that the rate of tax might be changed.

Justice Stone had an opportunity to distinguish the *Untermyer* case and to develop the principles of permissible retroactive tax legislation in his often-quoted opinion in *Welch* v. *Henry* (1938) 305 U.S. 134. In holding that the State of Wisconsin could constitutionally tax in 1935 previously untaxed income received by the taxpayer in 1933 Justice Stone observed that one criterion was whether the taxpayer could reasonably have anticipated the tax and that in each case "it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation" (p. 147). He concluded (p. 150) that there was a period beyond which a taxing statute would be obviously unconstitutional in its backward reach but that a legislative generally had authority to tax those prior but "recent transactions" referred to in *Cooper* v. *United States* (1930) 280 U.S. 409, 411 (*supra*).

Sales and use taxes.—Congress has normally applied new excise taxes to sales and purchases made subsequent to the effective date of the tax act. In these cases there was no need to depart from the policy of giving the business community time to prepare selling arrangements. However, Congress has imposed on merchandise held for sale new floor stock taxes based on prior purchase and sale prices, thus altering retroactively the price of the inventory. See, e.g., 26 U.S.C. 4226. Congress also raised the rates of excise taxes on distilled spirits held in bond, which increase related back to the levy of the tax on distillation without impairing the constitution. *Schenley Distillers* v. *United States* ((C.A. 3, 1958) 255 F. 2d 334, cert. denied (1958) 358 U.S. 835). Moreover, Congress at one time applied a use tax to the prior use of foreign property, which was upheld against the claim that the taxpayer was deprived of due process of law. *Billings* v. *United States* ((1914) 232 U.S. 261). In addition, Congress has authorized the Commissioner of Internal Revenue to apply his rulings with respect to liability for excise taxes on sales with retrospective effect, 26 U.S.C. 7805(b), and the courts have not objected; e.g., see *Exchange Parts Co.* v. *United States* ((Ct. Cl. 1960) 279 F. 2d 251).

The States, however, have enacted excise taxes on sales and use of property applying explicitly to transactions over periods prior to the date of the act. These "use" taxes apply to purchases of property subject to sales tax on which the sales tax has not been paid. The courts of final appeal in a number of States have held the retroactive application of such taxes to be consistent with the due process clauses of the 14th amendment and of the State constitutions, provided that the application was to relatively recent transactions. In doing so, the courts based their holdings primarily on *Cooper* v. *United States* ((1930) 280 U.S. 409), and Justice Stone's reasoning in *Welch* v. *Henry*, *supra*. These State cases were decided in various parts of the country over a number of years. They are:

1. *Lacidem Realty Corp.* v. *Graves* ((1942) 288 N.Y. 354, 43 N.E. 2d 440). Here the New York Court of Appeals permitted the application of the State utility tax law of 1941 to sales of electric current subsequent to January 1, 1940, under the "prior but recent" transactions doctrine of the *Cooper* case but rejected the application of the law to sales since May 1937 on the grounds that such extended retroactivity was harsh and oppressive, citing *Welch* v. *Henry*.

2. *Garrett Freight Lines, Inc.* v. *State Tax Commission* ((1943) 103 Utah 390, 135 P. 2d 523). The Supreme Court of Utah on the authority of *Welch* v. *Henry* and after extensive consideration of the purpose of the legislation upheld the application of the State excise tax on the use of diesel fuel from January 1, 1941, to May 13, 1941, the date of the passage of the act. The court considered that the legislature might reasonably place users of diesel oil on the same basis as users of gasoline for a period commencing with the beginning of the year although 5 months prior to the effective date of the act.

3. *Shirks Motor Express Corp.* v. *Messner* ((1953) 375 Pa. 450, 100 A. 2d 913), appeal dismissed and rehearing denied ((1954) 347 U.S. 941, 970). Here the Supreme Court of Pennsylvania, quoting from *Welch* v. *Henry*, found constitutional an amendment approved December 27, 1951, to the State's excise tax on the gross receipts of motor carriers, which eliminated for the calendar year 1951 credits previously allowed for registration fees and local use taxes. This in effect applied the local use tax retroactively for 1 year, even though as the court pointed out "the nature and amount of the increase in the tax could not have been anticipated" (pp. 918, 919).

4. *National Can Corp.* v. *State Tax Commission* (1959) 220 Md. 418, 153 A, 2d 287, appeal dismissed (1960) 361 U.S. 534). This case upheld a statute passed in 1958 which had the effect of ratifying the practice of assessing real property differently from personal property subsequent to January 1, 1957. In finding that principles of retroactivity apply no differently to an ad valorem tax, the court held the statute consistent with due process under the *Welch* v. *Henry* rule (at 301). It distinguished its earlier decision in *Comptroller of the Treasury* v. *Glenn L. Martin Co.* ((1958) 216 Md. 235, 140 A. 2d 288) on the grounds that the retroactive application of the statute involved in that case, namely, from 3 to 6 years, could not be upheld because it did not fall within the "recent transactions" rule. The *Martin* case had involved the retroactive reach of sales and use taxes but had recognized that a sales and use tax may have a retroactive effect, if not extending beyond a reasonable period.

5. Similar to the *Martin* holding were two earlier decisions in Washington which held that a 1939 use tax amendment applied retroactively as far back as 4 years exceeded the limit of reasonable retroactivity established in *Welsh* v. *Henry*. *State* v. *Pacific Tel. & Tel. Co.* ((1941) 9 Wash. 2d 11, 113 P. 2d 542); *Northern Pacific Ry. Co.* v. *Henneford* ((1941) 9 Wash. 2d 18, 113 P. 2d 545).

From the foregoing cases it is clear that taxation may apply constitutionally to prior but recent transactions, whether the tax is an income tax or an excise tax, whether the excise tax is on gross receipts or on completed transactions, and where the purpose of the legislature is solely to raise revenue without additional considerations of public policy. Consequently, where Congress has compelling reason and purpose to apply an excise tax on purchases to the period following the date when the President recommends such taxation, Congress may have confidence that the application of the tax to such a prior but recent period would be upheld as consistent with due process. See *Combs* v. *United States* ((D.C. Vt. 1951) 98 F. Supp. 749), applying retroactively for a month a new meat inspection charge.

The President's message as notice

The conclusion that the proposed legislation would be constitutional because, following the State court cases, it would reach only recent prior transactions is further supported by the consideration that the taxpayer is given notice of the probability of the tax by the President's message. Modern Federal courts and recent tax commentators have concluded that where a taxpayer has notice of the likelihood of the imposition of a tax he cannot successfully complain that its application to him is arbitrary. This importance of notice appears as early as the case of *United States* v. *Hudson* ((1937) 299 U.S. 498), *supra*, which pointed out that the sale of silver bullion occurred after the President's tax message calling for a tax on such sale. A similar reasoning is expressed in *Wilgard Realty Co.* v. *C.I.R.* ((C.C.A. 2d 1942) 127 F. 2d 514, cert. denied (1942) 317 U.S. 655). Here the court applied a provision of the 1939 revenue act to a sale occurring 7 years prior thereto on the grounds that the 1939 act merely conformed with the expectation of the taxpayer in 1932; consequently, the taxpayer had no ground for complaint. In *Gillmor* v. *Quinlivan* ((N.D. Ohio 1956) 143 F. Supp. 440) the sale, the gains from which were made taxable as ordinary income by a subsequent act, had taken place after the Ways and Means Committee had announced its tentative decision recommending the tax change. The retroactivity to the date of the announcement was held reasonable. In *Neill* v. *Phinney* ((C.A. 5 1957) 245 F. 2d 645) excess profits tax acts passed in January and October 1951 were held constitutionally retroactive to July 1, 1950. The enactments had been presaged by the Revenue Act of 1950 which had directed the Committee on Ways and Means and the Finance Committee to report to Congress excess profits legislation to be retroactive to July 1, 1950 (title VII, 64 Stat. 967). The court pointed out that the directors of the

corporation which was made retroactively subject to the tax had been indifferent to the congressional handwriting on the wall. They were bound to know that their liability for these taxes was probable "if not inexorable" and to have taken the taxation into account (pp. 649–653).

The importance of notice as support for the constitutionality of retroactive tax legislation is emphasized by Hochman (73 Harvard Law Review 692 (1960)) writing on "The Supreme Court and the Constitutionality of Retroactive Legislation." He concludes that the primary consideration is the ability of the taxpayer "at the time of the transaction in dispute" to foresee the tax (p. 706). A similar conclusion is expressed in the article on "Retroactivity in Federal Taxes" by Novik and Petersberger ((1959) 37 Taxes 407) in which Federal cases emphasizing the factor of notice of pending legislation are discussed.

The President's message calling for a tax on the acquisition of foreign obligations and securities from the time of his announcement presents the tax as an immediate means of reducing the deficit in this country's international transactions and defending its gold reserves. The message came in the midst of congressional hearings and congressional and administration statements on the need for action to reduce the unfavorable balance. The message should, consequently, be sufficient warning to any prudent investor that any purchase thereafter would be subject to tax for the compelling reason that an outward rush of dollars in anticipation of the act must be prevented.

Moreover, in a matter vital to the international monetary position of the United States, the President speaks with exceptional weight and importance, as he is the recognized organ of the Nation in matters of foreign affairs, *United States* v. *Curtiss-Wright Corp.* ((1936) 299 U.S. 304).

Factor of subsequent and periodic payment

The reasonableness of the legislation is further enhanced by the fact that it provides only for subsequent and periodic payment of the tax. The tax is not due on the date of enactment or the date of each purchase but at the time of filing of a quarterly statement covering past acquisitions. The amount of the tax under the new legislation would, therefore, depend on the taxpayer's prior acquisitions to that period. In this respect, the tax would be similar to the excise taxes on business which are measured by events prior to the enactment of the tax without violating the due process clause. The permissibility of measuring a subsequent excise tax by previous business has been established since the cases of *Flint* v. *Stone Tracy* ((1911) 220 U.S. 107), *supra*, and *Hecht* v. *Malley* ((1924) 265 U.S. 144), *supra*.

Additional powers of Congress

The proposed tax legislation is not recommended or enacted solely for revenue purposes. Its basic objective is to equalize the terms upon which capital is raised in this country by foreign borrowers and issuers in order to affect the amount of foreign commerce in this area and to protect the currency against any possibility of devaluation which might arise from an unfavorable balance of payments and the resulting drain on U.S. gold. A tax law may accomplish a regulatory purpose, as demonstrated in the various chapters of the Internal Revenue Code of 1954 providing for regulatory taxes (26 U.S.C., chs. 39-53). Taxes may also be laid in aid of another power of Congress, particularly the power to coin money and regulate the value thereof, *Veazie Bank* v. *Fenno* ((1869) 75 U.S. (8 Wall.) 533), and to regulate interstate and foreign commerce, *Rodgers* v. *United States* (C.C.A. 6 1953) 138 F. 2d 992).

Furthermore, Congress has authority to make all laws necessary and proper to carry into effect its delegated powers (art. I, sec. 8, clause 18). When Congress moves to avert or cure a major currency crisis it may draw upon its delegated powers, including this ancillary power, to accomplish a purpose which it might not be able to accomplish relying upon only one delegated power. This is the reasoning and importance of the *Legal Tender Cases* ((1870) 79 U.S. (12 Wall.) 457). In this case the Court upheld the power of Congress to modify preexisting contracts for the payment of private debts so as to require the payment of such debts in the currency it designated legal tender. The Court found that the congressional enactment was based upon several of the powers of Congress and its ancillary authority to employ every means necessary for the execution of its acknowledged duties, and that the act could not be defeated by the due process clause.

Conclusion

The circumstances, therefore, under which the proposed tax legislation would be enacted would undoubtedly lead the Supreme Court to conclude that the limited period of retroactivity of the tax was not only reasonable but necessary in order to prevent an excessive outflow of capital in anticipation of the tax legislation and that the President's message provided adequate notice to satisfy the due process clause. Moreover, the Court would, in all probability, recognize that Congress could call upon its powers to regulate the value of money and to regulate foreign commerce, as well as its taxing power, to prevent an international currency crisis by imposition of a tax on the purchase of foreign obligations and securities following the date the President announced its necessity. In such a decision the Court might also stress the preeminent power of the President in the management of foreign affairs.

Senator BENNETT. It is pointed out to me that the case of *Untermyer* v. *Anderson*, decided in 1927 with respect to the retroactivity on a gift tax found that that tax was illegal because it was—the tax was unconstitutional because the retroactivity was excessive.

Secretary DILLON. Yes. Well, this is discussed in the opinion fully and the basic case which seems to be the most guiding case of the Supreme Court currently—is a later case, called *Welch* v. *Henry* which was decided in 1938, which went into this in great detail. Since it was a later case, it overrides the earlier case.

Senator BENNETT. Well, Mr. Chairman, I have some more material that I would like to work over a little bit and so I would like to yield at the moment with the thought that I might want to come back again for some more questions.

Senator SMATHERS. All right, Senator Bennett.

Mr. Secretary, let me just ask one question and I will go back to Senator Williams.

The only complaints I have received in my office with respect to this particular proposal comes from American Underwriters who are greatly concerned about the fact that if this bill is enacted into law, not only will it stay in effect until December 1964 but probably will be continued and that their position will finally be destroyed.

What do you have to say about that, Mr. Secretary?

Secretary DILLON. Well, I dont' think that that is a valid opinion. I think it is an argument that may be made, and if I were in their position, I would make. But, in the first place, I don't think the tax will be continued indefinitely. There is no reason why it should be, because more fundamental factors should be, and are, the basis of our efforts to reach balance in our payments. When those come fully into play, hopefully by the end of 1965, the tax will no longer be necessary.

At that time or whenever that time comes—even if it is a year or two later, which I do not expect it to be, but even if it is—the ingenuity and skill and the size of the New York market, I am sure, will be such that even after the way that foreigners will have developed their markets, New York will immediately again become the dominating place.

Certainly if it does not, the investment banking fraternity are not the sort of men I used to know when I was in the business.

Senator SMATHERS. You don't have any fear then that having the Western European and developed foreign country markets become powerful and influential in this field that they will finally in the long run challenge New York's position as the financial center of the world?

Secretary DILLON. No. I think it is perfectly clear that, if there is to be a good balance in the world, there is a limit to the amount that can be done in the way of portfolio lending in any one market. I think it is much more healthy to have a more balanced world market where the European countries will, as a matter of practice, more usually take care of the bulk of their own requirements, and help some of those countries that are not in a position to raise their own capital as well, and we would do the same.

But certainly the U.S. market will continue to be and should be—there is no reason why it shouldn't be far larger than any other, and I would think larger than all European markets combined.

Senator SMATHERS. With respect to the retroactive effective date of this proposal, has any American underwriter that you know of taken the matter to court and challenged the constitutionality of the action taken by the Treasury Department?

Secretary DILLON. I don't think there is any question about that.

Senator SMATHERS. I mean challenged even your regulations or your authority to do it?

Secretary DILLON. No. Of course, I don't think they could or would until the law had been passed, but we haven't heard any serious views on that subject.

I think it is rather interesting to note that the minority report in the Ways and Means Committee, which was signed by some of the minority of the Ways and Means Committee, but not by all of them, did not make this point. It was apparently gone into carefully in the hearings and they decided the only practical way to make this tax work, if it was going to be enacted, was to have that July effective date, so they supported the majority of the committee on that subject. The reason is perfectly clear. If you would signal to the world that you were going to put something on at an indefinite day in the future, we would have had a fairly tremendous demand on our market, a tremendous outpouring of funds such as we have never seen before. We had seen something we had never seen before already in the first 6 months, but the demand would have gone far beyond that. We clearly couldn't have stood that, and the consequences for the dollar and our balance of payments would have been unforeseeable but certainly very dire.

Senator SMATHERS. Mr. Secretary, would it not be possible, even without Congress having passed a law for some American underwriter, to challenge the action which you have taken on the basis, (a) that there is no law authorizing you to do this. I am just curious as a legal question. Wouldn't there have to be some way to test it?

Secretary DILLON. I am not a lawyer, but I don't quite see how because we haven't done anything except propose that the tax be passed effective, on a retroactive basis, to a certain date.

Senator SMATHERS. So it is something that still just remains a proposal and there has been no action against your regulation?

Secretary DILLON. No; we have not taken any action of any kind except we have worked with the stock exchange and the National Association of Security Dealers particularly on the question of dealing in outstanding securities and we have developed in cooperation with them a simplied way in which their transactions could be carried on, and have been carried on workably under those arrangements.

It would fit in with the tax should it be enacted. That wasn't anything we prescribed. It was something they developed and we agreed with it.

Senator BENNETT. Would the Senator yield for a question at this point? I would like to ask the Secretary, What has been the general effect of this proposal on the market for outstanding foreign securities in the United States?

Secretary DILLON. Well, the market for outstanding foreign securities is still active. Those that are trading among Americans are free of tax and account for the bulk of the trading. They trade at generally very small amounts—half a point, something like that, a quarter of a point—higher than trades in stocks owned by foreigners and sold to Americans.

In other words, there is a slight premium where the tax doesn't have to be paid. Immediately after the tax was suggested some of these premiums were higher, but they have gradually dropped and there aren't any very large premiums any more. There are some small premiums on securities trading here among Americans which is natural because they are free of tax.

Senator BENNETT. Because the owners are sure they will not be taxed under any circumstances, the owners——

Secretary DILLON. The purchasers.

Senator BENNETT. The purchasers who consider buying from foreigners are doing it at their own risk?

Secretary DILLON. That is right.

Senator BENNETT. Thank you, Mr. Chairman.

Senator SMATHERS. Mr. Secretary, if the effective date, if this proposed legislation is changed, does it not mean those those people who gambled on the fact that the Congress would not act have had a rather profitable ride, whereas those who expected apparently the administration to prevail will have suffered?

Secretary DILLON. That is correct. There are a few people who clearly have done that, although they are very few in number. The Securities and Exchange Commission has noticed a few cases where individuals have bought foreign stock of a foreigner in the market and sold it to an American at the same time—identical transactions. They are obviously arbitrating and making three-eighths of a point or half a point, which would be a profit only if there is no tax. If the tax went into effect, they would obviously suffer a considerable loss, if they intend to pay the tax. There hasn't been much of that, but there has been some. Certainly a change in the law couldn't at this point benefit anyone except people who have operated in that way.

We can give you an example of that. It doesn't have any names, but just shows some of the sales in one well-known stock, Royal Dutch, that were done in one day in May. It shows transactions, literally within the same minute, of a thousand shares bought on the foreign market and sold by the same person on the American market on the New York Stock Exchange.

Senator WILLIAMS. In billing their customers have they been adding on this extra charge as a tax?

Secretary DILLON. No; the way the situation works, Senator, is that we worked out this—or rather the exchange worked it out, we thought it was fine—procedure under which all sales on the New York

Stock Exchange in the regular course of business are presumed to be American owned securities and free of tax. The responsibilities for determining that rests with the selling broker. If he knows shares are foreign held, and he knows what stock he is selling, he must so indicate when he offers it for sale, and then it is marked as a special foreign transaction. There aren't very many of those.

The great bulk of the transactions are of the other nature, the tax-free nature.

When he does have a sale of foreign securities, the purchaser gets his regular receipt, his regular transaction voucher, and it says that he has purchased so many shares but they are marked with a "F" so they are foreign. He knows he is then subject to the tax.

The provisions of the tax say that, after the end of the first quarter following enactment of the tax, the tax will be due on everything that has been taxable since the effective date of the tax, which would be July 18, 1963.

So he hasn't been billed yet. The purchaser will have to pay it at that time. If this is enacted in the third quarter, the tax would be due October 31.

Senator SMATHERS. Senator Williams, do you have any more questions?

Senator WILLIAMS. I have some more questions but I will yield to Senator Morton.

Senator MORTON. Go ahead.

Senator WILLIAMS. This tax, it seems to me, is being collected either from the customer or by the broker at some point. It is being paid currently, is it not?

Secretary DILLON. Oh, no.

Senator WILLIAMS. There is no tax being collected?

Secretary DILLON. No tax being collected?

Senator BENNETT. No.

Senator WILLIAMS. If after this is enacted, some customer refuses to pay the tax could you put the penalty retroactively on this?

Secretary DILLON. There would be civil penalties, which are really to assure the collection of the tax, but the criminal penalties for willful false filing and things of that nature cannot take effect until after the bill is enacted because, under our Constitution, they can't be retroactive.

Senator WILLIAMS. You mentioned the fact that the bank loans have increased somewhat in recent months. Do you have the figures showing the bank loans for the last 3 or 4 years?

Secretary DILLON. Yes, we can give you those. We will submit a table for the record. They have increased quite substantially. This increase——

Senator WILLIAMS. Do you have those with you now?

Secretary DILLON. Yes; I have some figures on bank loans which I would be glad to give you.

Senator WILLIAMS. Would you give them to us?

Secretary DILLON. They are really of two types. There are long-term bank loans and short-term bank loans.

Senator WILLIAMS. Would you give them separately and then the totals?

Secretary DILLON. Yes. For the long-term bank loans they increased by $153 million in 1960; $133 million in 1961; and $127 million in 1962.

Senator WILLIAMS. That is increases?

Secretary DILLON. Increases.

Now in 1963 they decreased in the first quarter by $27 million, and then in the second quarter, which is when I had mentioned the increase really started—this was prior to our announcement of the tax or to any effect of the tax, they increased by $177 million. That was more in that quarter than in any of the preceding years.

Senator WILLIAMS. What was the increase for the year of 1963?

Secretary DILLON. Well, in the third quarter they increased another $114 million, and in the fourth quarter the increase was large; it was $302 million, which excludes $150 million of trade credits that a U.S. corporation sold to the banks, so there was actually no balance-of-payments effect. The total then for the year was $566 million. Then, in the first quarter of this year, they were also high but the increase was less than in the fourth quarter. They went from an increase of $300 million to $219 million.

Senator WILLIAMS. There had been an increase of $225 million in the first quarter of this year?

Secretary DILLON. That is right. And the indications are that in the second quarter that will be considerably smaller.

Senator DOUGLAS. Would the Senator from Delaware yield for just one question?

Senator WILLIAMS. Sure.

Senator DOUGLAS. Are these increases cumulative, Mr. Secretary, or are they increases in terms of a given fixed base?

Secretary DILLON. They are cumulative changes in the outstanding claims on foreigners reported by banks.

Senator DOUGLAS. They are cumulative. That is each year is an addition over the previous year?

Secretary DILLON. Yes.

Senator DOUGLAS. Therefore, overall, you could get a very large total?

Secretary DILLON. Yes.

Senator DOUGLAS. Will you submit for the record what the totals have been?

Secretary DILLON. Oh, yes; will be glad to.

Senator WILLIAMS. That is what I was going to ask, what the totals were for each of the years 1960 through so we can see what the total increase was.

Secretary DILLON. We can give you the totals for each year and the increases.

Senator WILLIAMS. Do you have those figures now?

Secretary DILLON. No.

Senator WILLIAMS. You don't have the total figures for the bank loans of each of the 5 years?

Secretary DILLON. No, I just have these in the form of increases in the outstanding amounts which is the usual way we have been looking at them but we can easily put it together in that form.

Senator WILLIAMS. A rough, rapid calculation shows about a billion and a quarter increase on an annual basis; is that about correct?

Secretary DILLON. No, they increased the total for 19- ---

Senator WILLIAMS. That is 64- ---

Secretary DILLON. The first quarter if you multiply that out.

Senator WILLIAMS. No, not multiplying it out. If these are increases each year over the preceding year does that not mean that 1964 is running about a billion and a quarter higher than 1960?

Secretary DILLON. Than 1960, I see. Yes, the total outstanding is that much higher.

Senator WILLIAMS. About a billion and a quarter?

Secretary DILLON. About a billion and a quarter net increase since the beginning of 1960.

Senator WILLIAMS. Yes.

On private investments, how does that total run over that same period?

Secretary DILLON. Well, that grew much more rapidly as the tables here show.

Portfolio purchases of new issues table 2 shows it—jumped from \$555 million in 1960 and \$523 in 1961 to \$1,076 million in 1962, and in the first half of 1963, before the tax was proposed, \$1,858 million at a seasonally adjusted annual rate. Actually the total was over a billion dollars—just over a billion dollars—for the first half of 1963, which was approximately the same as it was for the entire year 1962. So the absolute amounts have gone up much more than these bank loan figures.

Senator WILLIAMS. Now again, are these increases each year as compared with the preceding year?

Secretary DILLON. These are total purchases.

Senator WILLIAMS. And you will furnish for——

Secretary DILLON. The same way.

Senator WILLIAMS. And you will furnish the total for each?

Secretary DILLON. We will be glad to do the same thing, yes.

Senator BENNETT. Will the Senator yield?

Senator WILLIAMS. Yes.

Senator BENNETT. I think it will be helpful to the committee, Mr. Secretary, if you would assume that bank loans and the sale of new issues represented as a total of the two a penetration of our market, so let's go back to 1960, if that is where Senator Williams wants to start, and total those two for 1960, 1961, 1962, and 1963, the full year, and then give us the first quarter of 1964.

Secretary DILLON. Yes, we will be glad to do them both separately and then total them together and give them to you every way you want them.

Senator BENNETT. That is right. Then we can see the movement.

Secretary DILLON. Every way you want.

Senator WILLIAMS. As I understand it the figures we have been using have been capital investments and long-term bank loans?

Secretary DILLON. That is right.

Senator WILLIAMS. Have you short-term bank loans in the same category?

Secretary DILLON. Yes, sir; they have also increased but they move around with much more flexibility.

Senator BENNETT. They are much more fluid?

Secretary DILLON. They have to do with trade flows and things like that.

Senator WILLIAMS. But do you have the similar statistics and report on it?

Secretary DILLON. Yes, sir; the statistics show for the year 1960 they increased by $995 million, for the year 1961 by $1,125 million; for the year 1962 it dropped to $324 million; for the year 1963 they increased again to $721 million, and they were larger again in the first quarter of 1964. They were $421 million.

But they vary very much between quarters because last year, when the net increase was $721 million, there were two quarters in which they decreased and two quarters in which they increased, and in each case by over $400 million.

So they are much more erratic on a quarterly and on an annual basis, but we will be glad to give you the same statistics.

Senator WILLIAMS. You will furnish the same statistics for that?

Secretary DILLON. Yes.

(The material referred to follows:)

TABLE 1.—*Net purchases of foreign securities by U.S. residents and net changes in bank credit extended to foreigners, 1960–63 and 1st quarter, 1964*

[In millions of dollars]

	Net purchases of foreign securities	Net increase in long-term bank claims [1]	Total, long term	Net increase in short-term bank credit [2]	Total
1960	864	153	1,017	639	1,656
1961	910	133	1,043	953	1,996
1962	1,172	127	1,299	386	1,685
1963:					
I	540	−27	513	−87	426
II	586	177	763	264	1,027
III	151	114	265	−28	237
IV	−2	302	300	385	685
Total	1,275	566	1,841	534	2,375
1964: I	[3] 33	219	252	275	527

[1] Mostly loans.
[2] Mostly loans and acceptance financing; excludes collections and foreign currency claims, which are mostly for account of customers.
[3] Preliminary.

TABLE 2.—*Net purchases or sales of foreign securities by U.S. residents, 1960–63 and 1st quarter, 1964*

[Millions of dollars; purchases (+) sales (−)]

	By years—				By quarters—				
	1960	1961	1962	1963	1963				1964
					I	II	III	IV	I
New issues of foreign securities purchased by U.S. residents	555	523	1,076	1,260	481	518	183	87	[1] 132
Net purchases or sales of outstanding foreign securities by U.S. residents	309	387	96	6	59	68	−32	−89	[1] −99
Total, U.S. purchases or sales of foreign securities	864	910	1,172	1,275	540	586	151	−2	[1] 33

[1] Preliminary.

Source: Survey of Current Business.

TABLE 3.—*Net changes in claims on foreigners reported by U.S. banks,[1] 1960–63 and 1st quarter, 1964*

[Millions of dollars; increases (+) decreases (−)]

	By years—				By quarters—				
	1960	1961	1962	1963	1963				1964
					I	II	III	IV	I
Short-term claims:									
Collections and foreign currency claims (mainly for account of customers)	356	172	−63	187	10	138	−68	107	146
Other (dollar) claims (mainly loans and acceptances)	639	953	386	534	−87	264	−28	385	275
Total, short term	995	1,125	324	721	−77	402	−96	492	421
Long-term claims (mainly loans), total	153	138	127	[2] 566	−27	177	114	[2] 302	219
Total, long- and short-term claims	1,150	1,261	451	1,287	−104	579	18	794	640
(Of which, claims on Japan)	485	675	262	532	12	152	24	343	331

[1] Includes claims for account of banks' customers as well as loans, acceptances, and other claims for banks' own account.

[2] Excludes sales of about 150,000,000 of outstanding trade credits to the banks by a U.S. corporation.

NOTE.—Details may not add to totals because of rounding.

Source: Department of Commerce and Treasury Department.

TABLE 4.—*Total outstanding short- and long-term claims on foreigners reported by U.S. banks*

[In millions of dollars]

Claims reported as of—	Total, short term [1]	Long term	Total [1]	Of which claims on Japan
Dec. 31, 1959	2,599.0	1,545.1	4,144.1	339.6
Dec. 31, 1960	3,594.2	1,698.4	5,292.6	825.0
Dec. 31, 1961	[2] 4,777.3	[3] 2,033.8	[2,3] 6,811.1	[2] 1,551.7
Dec. 31, 1962	5,100.9	2,160.4	7,261.2	1,814.2
Mar. 31, 1963	5,023.9	2,133.0	7,156.8	1,827.1
June 30, 1963	5,430.9	[4] 2,396.5	[4] 7,827.4	1,982.7
Sept. 30, 1963	5,334.8	2,510.3	7,845.1	2,008.5
Dec. 31, 1963	5,826.7	[5] 3,005.1	[5] 8,831.8	[5] 2,392.0
Mar. 31, 1964	6,247.0	3,224.2	9,471.2	2,676.3
Apr. 30, 1964	6,377.3	3,251.2	9,628.6	2,675.2

[1] Excludes claims held by the Exchange Stabilization Fund.
[2] Short-term claims include $57,900,000 reported by banks initially included as of Dec. 31, 1961. Of this amount, claims on Japan amount to $51,900,000.
[3] Includes $200,000,000 classified as a direct investment transaction.
[4] Includes claims of $86,000,000 previously held but first reported as of May 31, 1963.
[5] Includes claims of $193,000,000, reported by banks for the first time as of Dec. 31, 1963, which includes about $150,000,000 of trade credits sold to the banks by a U.S. corporation but in part represents claims previously held but not reported by the banks. Included in this amount are claims of $46,400,000 on Japan.

NOTE.—Data for foreign securities held by Americans at the end of calendar years 1959-63 that may be directly compared with the figures for net purchases shown on table 2 are not available. However, the Department of Commerce has estimated that the value of all foreign securities held by United States residents at the end of 1962 was $11,802,000.

Source: Treasury Department.

Senator MORTON. This depends a lot on our volume of exports, does it not?

Secretary DILLON. It depends on the volume of exports and other factors. For instance, we have had a cycle of borrowing by Japan—and I think they are the biggest borrower here—depending on the status of the balance of payments of Japan. They borrow heavily when they need the funds, and then they get a little better and they pay off heavily and then they borrow heavily and it has been going like that.

Senator WILLIAMS. I understand that but I thought if we had those it would be helpful to the committee.

Secretary DILLON. Yes, we will be glad to submit those, Senator, along with the other data you asked for on bank lending.

Senator WILLIAMS. Now, you mentioned in your report about the improvement in our balance of payments and substantial reduction in our loss of gold in recent periods.

What do you anticipate for the next 6 to 12 months in that direction?

Secretary DILLON. Well, it is so difficult to look ahead.

Senator WILLIAMS. Assume the enactment of this bill.

Secretary DILLON. Even with this bill I have learned that prophesying balance of payments is a very unprofitable operation because it doesn't depend only on what action the United States may take, but it also depends on developments in all other countries of the world.

So it is not a very useful thing and you never can be too accurate when you prophesy ahead. But we see no reason why the present improvement which, as I said, suggests a balance of payments deficit for the fiscal year of $2 billion or maybe a little less, shouldn't continue through the remainder of this calendar year, so we wind up with a calendar year on about the same basis.

We would think that next year, everything being equal, we ought to do better because we do know that, as a result of actions that are currently underway, our Government expenditures overseas will be about half a billion dollars less in 1965 than they will be in 1964. So that will be a substantial improvement, and if nothing else changes it would reduce the deficit by about 25 percent.

We would hope there would be some other improvements besides but that is the best one can say looking ahead.

Senator WILLIAMS. To what extent do you attribute the reduction in the outflow of gold as resulting from our new method of financing: that is, borrowing direct from these countries with their currencies?

Secretary DILLON. I think that has had some effect, particularly last year. I don't think it had much this year because in the first 6 months of this year we have done very little of that. So I think that the fact that it has improved in the first 6 months is due to some other factors.

One of the main reasons, I think, has been that the other countries' surpluses—the counterpart of our deficit—last year and early this year seemed to have shifted somewhat from earlier times.

The underdeveloped countries as a whole, because of higher prices for their basic commodities, have been in surplus in the last year, and they like to hold dollars. They don't get any benefit out of gold, so there has been no demand by them for gold.

Also, private accounts have apparently needed dollars to finance their trade, or whatever they want them for, and they have increased their holdings of dollars, whereas the holdings of dollars of official governmental bodies have declined substantially. The figures for the end of April are back to what they were at the end of 1962, nearly 18 months ago—about three-quarters of a billion dollars less than they were at their high point. I think that has been the primary thing that has had the effect on this outflow of gold.

Of course, there has been one other thing which has to be taken into account. That is that there has been, particularly since last fall, a somewhat greater supply of new gold to the free world in view of the unusually heavy sales by the Soviet Union in the London market. That supply has also helped to meet the demand and so there has been less demand on us.

Senator WILLIAMS. Will you furnish for the record a list showing the extent of these borrowings and the countries involved and the rates of interest, and so forth, and the terms of the loans?

Secretary DILLON. We would be glad to. They are regularly published.

Senator WILLIAMS. I know they are, but I just thought if you would consolidate them at this point in the record.

Secretary DILLON. Yes.

(The material referred to follows:)

34-937—64——8

[illegible] to official institutions of foreign countries

[illegible]	[illegible]	Payable in	Issue date	Maturity date	Interest rate	Amount (dollar equivalent)		
						Issued	Retired	Total outstanding end of month
					Percent	In millions of dollars		
[illegible]	Certificates of indebtedness	Swiss francs	Various	3 months from date of issue.	1.25	46		46
		do	do	do	1.25		46	
1962: January	do.	do	Jan. 4, 1962	Apr. 4, 19[illegible]	1.25	23		48
		Italian lire	Jan. [illegible], 1962	Apr. 26, 19[illegible]	2.70	25		
February	do							48
March	do.	Swiss francs	Jan. 4, 1962	Apr. 4, 1962	1.25		23	75
		Italian lire	Mar. 9, 1962	June 8, 1962	2.75	50		
April	do.	do	Jan. 26, 1962	Apr. 26, 1962	2.70		25	75
			Apr. 26, 1962	July 26, 1962	2.75	25		
June	do.	do	Mar. 9, 1962	June 8, 1962	2.75		50	75
			June 8, 1962	Sept. 7, 1962	2.70	50		
July	do.	do	Apr. 26, 1962	July 26, 1962	2.75		25	75
			July 26, 1962	Oct. 26, 1962	2.90	25		
August	do.	do	Aug. 7, 1962	Nov. 7, 1962	2.85	75		150
September	do.	do	June 8, 1962	Sept. 7, 1962	2.70		50	150
			Sept. 7, 1962	Dec. 7, 1962	2.85	50		
October	Bonds	Swiss francs	Oct. 18, 1962	Jan. 20, 1964	2.75	23		
	Certificates of indebtedness	do	Oct. 22, 1962	Apr. 1, 1963	2.00	22		
	do	do	do	July 1, 1963	2.00	26		221
	do	Italian lire	July 26, 1962	Oct. 26, 1962	2.90		25	
	Bonds	do	Oct. 26, 1962	Jan. 27, 1964	3.00	25		
November	Certificates of indebtedness	do	Aug. 7, 1962	Nov. 7, 1962	2.85		75	
	Bonds	do	Nov. 7, 1962	Feb. 7, 1964	3.00	75		299
	do.	Swiss francs	Nov. 8, 1962	Mar. 9, 1964	2.75	28		299
	do	Italian lire	Nov. 30, 1962	Feb. 28, 1964	3.00	50		
December	Certificates of indebtedness	do	Sept. 7, 1962	Dec. 7, 1962	2.85		50	299
	Bonds	do	Dec. 7, 1962	Mar. 9, 1964	3 [illegible]	50		

1963:								
January	do	Swiss francs	Jan. 24, 1963	May 25, 1964	2.82	30		
		German marks	do	Apr. 24, 1964	3.13	50		429
		do	do	July 24, 1964	3.18	50		
February	do	do	Feb. 14, 1963	Nov. 16, 1964	3.09	50		529
			do	Feb. 15, 1965	3.14	50		
March	do	Italian lire	Oct. 26, 1962	Jan. 27, 1964	3.00		25	529
			Mar. 29, 1063	Mar. 29, 1965	3.27	25		
April	Certificates of indebtedness	Swiss francs	Oct. 22, 1962	Apr. 1, 1963	2.00		22	
	Bonds	do	Apr. 1, 1963	July 1, 1964	2.82	22		
	do	do	Apr. 4, 1963	Sept. 4, 1964	2.83	23		577
	do	Austrian schillings	Apr. 26, 1963	Oct. 26, 1964	3.23	25		
May	do	Swiss francs	May 16, 1963	Nov. 16, 1964	2.82	23		
		Belgian francs	do	May 16, 1965	3.26	20		630
		do	May 20, 1923	May 20, 1965	3.22	10		
June	do	Italian lire	Nov. 7, 1962	Feb. 7, 1964	3.00		75	630
			June 28, 1963	June 28, 1965	3.30	75		
July	Certificates of indebtedness	Swiss francs	Oct. 22, 1962	June 1, 1963	2.00		26	
	Bonds	do	July 1, 1963	Jan. 1, 1965	2.89	25		655
	do	German marks	July 11, 1963	July 11, 1965	3.55	25		
August	do	do	Aug. 28, 1963	Aug. 28, 1965	3.66	50		705
September	do	Italian lire	Nov. 30, 1962	Feb. 28, 1964	3.00		50	705
			Sept. 30, 1963	Sept. 30, 1965	3.69	50		
October	Certificate of indebtedness	Swiss francs	Oct. 31, 1964	Oct. 30, 1964	3.54	30		735
December	Bonds	Austrian schillings	Dec. 11, 1963	June 11, 1965	3.83	25		760
1964:								
January	do	Swiss francs	Oct. 18, 1962	Jan. 20, 1964	2.75		23	760
			Jan. 20, 1964	Apr. 20, 1965	3.61	23		
March	do	do	Nov. 8, 1962	Mar. 9, 1964	2.75		28	710
			Mar. 9, 1964	July 9, 1965	3.71	28		
		Italian lire	Dec. 7, 1962	Mar. 9, 1964	3.00		50	
April	do	do	Mar. 29, 1963	Mar. 29, 1965	3.27		25	
			June 28, 1963	June 28, 1965	3.30		75	
			Sept. 30, 1963	Sept. 30, 1965	3.69		50	
		German marks	Apr. 1, 1964	Oct. 1, 1965	4.04	50		762
			do	Nov. 1, 1965	4.05	50		
			do	Dec. 1, 1965	4.06	50		
			do	Jan. 1, 1966	4.07	50		
			Jan. 24, 1963	Apr. 24, 1964	3.13		50	
			Apr. 24, 1964	July 26, 1965	3.93	50		
May	do	Swiss francs	Jan. 24, 1963	May 25, 1964	2.82		30	
			May 25, 1964	Sept. 27, 1965	3.84	30		832
			do	Aug. 25, 1965	3.37	70		

Source: Monthly Treasury Bulletin. Information in this table covers transactions from inception through June 30, 1964. There were no transactions in June 1964. On July 1 the Swiss franc denominated bond equivalent to $22,000,000 which matured on that date was renewed for a further 15 months, and the equivalent of approximately $151,000,000 in German mark bonds were newly issued.

Outstanding Treasury foreign currency security issues

Currency	Foreign currency	U.S. dollar equivalent	Interest rate (percent)	Date issued	Maturity (months)	Payment date
	Millions of units	*Millions of units*				
Austrian schillings	650	25	3.23	Apr. 26, 1963	18	Oct. 26, 1964
	650	25	3.83	Dec. 11, 1963	18	June 11, 1965
Total, Austrian schillings		50				
Belgian francs	1,000	20	3.26	May 16, 1963	24	May 16, 1965
	500	10	3.22	May 20, 1963	24	May 20, 1965
Total, Belgian francs		30				
German marks	200	50	3.18	Jan. 24, 1963	18	July 24, 1964
	200	50	3.09	Feb. 14, 1963	21	Nov. 16, 1964
	200	50	3.14	Feb. 14, 1963	24	Feb. 15, 1965
	100	25	3.56	July 11, 1963	24	July 11, 1965
	200	50	3.66	Aug. 28, 1963	24	Aug. 28, 1965
	200	50	4.04	Apr. 1, 1964	18	Oct. 1, 1965
	200	50	4.06	Apr. 1, 1964	19	Nov. 1, 1965
	200	50	4.06	Apr. 1, 1964	20	Dec. 1, 1965
	200	50	4.07	Apr. 1, 1964	21	Jan. 1, 1966
	200	50	3.93	Apr. 24, 1964	15	July 26, 1965
	200	50	3.83	July 1, 1964	19	Feb. 1, 1966
	200	50	3.84	July 1, 1964	20	Mar 1, 1966
	200	50	3.85	July 1, 1964	21	Apr. 1, 1966
Total, German marks		628				
Swiss francs	100	23	2.88	Apr. 4, 1963	17	Sept. 4, 1964
	130	30	3.54	Oct. 31, 1963	12	Oct. 30, 1964
	100	23	2.82	May 16, 1963	18	Nov. 16, 1964
	110	25	2.89	July 1, 1963	18	Jan. 1, 1965
	100	23	3.61	Jan. 20, 1964	15	Apr. 20, 1965
	120	28	3.71	Mar. 9, 1964	16	July 9, 1965
	130	30	3.84	May 25, 1964	16	Sept. 27, 1965
	[1] 300	70	3.37	May 25, 1964	15	Aug 25, 1965
	97	22	3.81	July 1, 1964	15	Oct. 1, 1965
Total, Swiss francs		275				
Total		983				

[1] Issued to the Bank for International Settlements.

NOTE.—Figures may not add to totals because of rounding. On July 1 the Swiss franc denominated bond equivalent to $22,000,000 which matured on that date was renewed for a further 15 months, and the equivalent of approximately $151,000,000 in German mark bonds were newly issued.

Senator WILLIAMS. To the extent that that type of loan is outstanding, it is, in effect, a guaranteed loan against a devalued dollar; is that not true?

Secretary DILLON. It could have that effect, but not in gold, because if the other currency devalues at the same time, as would be the likely result if there is a change in the value of the dollar, it wouldn't make any difference. But——

Senator WILLIAMS. To the extent that theirs is preceded by ours by 24 hours it does have that effect; does it not?

Secretary DILLON. To the extent that theirs is preceded by ours by 24 hours, it generally has that effect; yes.

Senator WILLIAMS. Yes.

I have no further questions at this time.

Senator SMATHERS. Senator Morton?

Senator MORTON. Mr. Secretary, the fact that you appear here today is because we do have a balance-of-payments problem.

Secretary DILLON. Most certainly; I wouldn't be here otherwise.

Senator MORTON. And had we not had such a problem on July 19, 1963, President Kennedy would not have sent this message to the Congress.

Secretary DILLON. That is very true. As I said, we asked for this tax with reluctance.

Senator MORTON. So we have to make some choice here. This is one method. The so-called capital issues committee is another method, and it seems to me that we are in a position of having to accept perhaps the lesser of two evils.

The effect of this tax really is about a 1-percent increase in interest rates on funds that are invested abroad from this country; is it not?

Secretary DILLON. That is correct.

Senator MORTON. In your colloquy with the Senator from Illinois, he indicated that there is a disparity between the price at which stocks in this country are selling and stocks in most of the European capitals, and I think you made the point that on the big board here it is probably 19 to 1, probably about 18½ to 1 on the American Stock Exchange, a little bit less in the Midwest, as opposed to some 13 to 14 in Germany; less than that, I assume in France, I believe in France it is a little less than that, and in Italy a little less than that.

Isn't the real reason for this difference, or one of the contributing factors for this difference, not that we have a speculative fever in this country, but that long-term interest rates generally are lower than elsewhere in this country and people are therefore going into stocks?

Secretary DILLON. I made that point, I think, in talking with the Senator from Illinois. I think that is one of the factors that is involved.

With this supply-and-demand relationship here, we have this big demand for stocks by these new institutions which were not investors in stocks 10 or 15 years ago on the same scale and which have become very heavy buyers since then without an equal increase in supply. I think it has been the reason why stocks are selling higher, probably the primary reason.

Senator MORTON. I, too, remember 1929 and, in fact, that was when I was a college graduate, I graduated from college before the crash and I lived pretty well during my senior year in college and if we wanted to live we would go down and buy some shares we never heard of and make a hundred dollars and then go to New York for the weekend.

After some of my colleagues here in Congress started berating the tobacco industry so heavily I thought tobacco stocks were a little cheap a while ago and I decided I would try to buy some, and I had to put up 70 percent, so I don't think we have the speculation which is putting the market up today in the sense we had in 1929.

Secretary DILLON. It is certainly quite different from what it was in 1929.

Senator MORTON. And if the Federal Trade Commission hadn't come out with that crazy report the other day I might have been better off with my stocks. [Laughter.]

You were discussing the date with Senator Smathers. You meant, of course, the beginning date, the July 19.

Now in that message of President Kennedy's, did he ask at that time for a terminal date, December 31, 1965?

Secretary DILLON. That is right.

Senator MORTON. Well, nearly a year has passed since without an enactment of this law. I don't know what the pleasure of the committee would be, but I think we would like to have your opinion of the fact that since a year has gone by would it not be wise, perhaps, to extend the date for 1 year?

You have to come up here, not only once a year, but sometimes two and three times a year for the debt limit, and I was trying to save you a little work on this, maybe if we give you 1 more year on this it would be logical.

Secretary DILLON. Well, we had made the original suggestion because that was a year after our efforts to reduce Government expenditures by a billion dollars would have had time to show its effects. We also felt that there were other indications of improvement of our balance of payments particularly in the trade area and our judgment has been proved correct in the last 9 months, for the trade balance has improved substantially. We hope that by the end of 1965 we would be in a position where this tax wouldn't any more be needed.

Also, part of our thinking was that we hoped the European markets would develop during that period so that they would be in a stronger position afterward to take more of the burden. I think they are developing, and so my own view is that, while it might have a certain administrative simplicity to extend the date a year further, unless it is very clear it is needed I wouldn't want to see it done. We can't see that it is clear, so we think that the end of 1965 date, which we hope we can meet, should be maintained.

Senator MORTON. Thank you very much. I will say, Mr. Secretary, that I don't think any of us are happy about having to take a step of this nature, but as one member of this committee, I think something has got to be done in this area and I think the proposal you have made here is perhaps, to me at least, as an individual Member of the Senate the least obnoxious.

Secretary DILLON. Thank you.

Senator SMATHERS. Senator McCarthy, do you have any questions?

Senator MCCARTHY. No questions.

Senator SMATHERS. Senator Douglas?

Senator DOUGLAS. First, I would like to correct a possible impression which the Senator from Kentucky may have inadvertently left about my earlier comments about inflation in stock prices.

I did not mean that inflation in stock prices is as great now as it was in 1929.

What I did wish to suggest was that inflation might well be present, and that it may have contributed to both the high level of stock prices and the high ratio of stock prices to actual earnings, with its consequent lowering of the rate of yield. I did wish to suggest, also, that this, in my judgment, is greater in this country than in, for example, Germany, and that, therefore, the long-term discrepancy between interest rates on investment in this country and investment abroad is not as great as the figures would indicate. I am speaking, of course, of matters of degree, and not matters of absolutes.

Now, the second question I would like to ask, with the indulgence of the chairman and the Secretary, is in reference to the letter which you addressed to the chairman of the committee under date of June 12,

which is embodied in this print of some 30 suggested amendments to the bill.

May I ask, Did you submit these amendments to the House Ways and Means Committee or are these amendments which have occurred to you since the passage of the bill by the House?

Secretary DILLON. Some of them have occurred prior and some since. They all occurred after the House Ways and Means Committee completed consideration of the bill. There was an unusually long period of time between the Ways and Means Committee action on the bill, which took place in early December, and the House passage. The bill did not, for one reason or another, did not come to the floor of the House until 3 months later—early in March—and therefore during that period a good many of these things were under study, and probably a number of them would have been ready, but under the procedures in the House, this bill came on the floor under a closed rule. Also the committee knew we had time in the Senate, and they knew we were working on modifications of this technical nature and we told them we were. Some of them—I can't say which were which—but some of them were well underway before the bill was actually passed by the House. Others of them were later.

Senator Douglas. This is the first time they have been formally proposed to a committee of the Congress?

Secretary DILLON. That is right.

I would like to say one other thing. While we take responsibility obviously for the content of them, we did work with congressional legislative drafting experts, and they concur in the language and the form of the amendments without having any responsibility for the substance, which is entirely ours. That took a certain amount of time to be sure to get them in proper form that way.

Senator DOUGLAS. Following up the question which was addressed to you by the Senator from Tennessee, I obviously have not had a chance to examine these in detail, but as I cast my eye down the contents which cover nearly two pages, it would seem to me that virtually all of these provide for some softening of the act itself.

Secretary DILLON. That is right.

Senator DOUGLAS. To what degree do you think this impairs the original purpose of the act?

Secretary DILLON. None whatsoever; as I said earlier, because all of these are in areas where we never meant the act to apply. In all of the major areas where we meant the act to apply we did not make any change.

I would say the change that represents the greatest shift is that one of these permits arbitrage transactions in stocks tax free between markets here and abroad, provided the sale is completed in the same day.

This permits a purchase from a foreigner and the resale in the foreign market on the same day. There was no provision for that before.

Well, obviously that sort of transaction would not hurt our balance of payments, and a number of companies specializing in that type of transaction had asked for some sort of provision like that. We studied it carefully and we couldn't see how it would affect our balance of payments so we made that suggestion. But other than that one, I

think all the rest are simply technical, I can give you one as an example. The bill provides that companies having long-term export paper not be taxed, and their paper—these are primarily manufacturing companies that get this paper—could be sold to a commercial bank. But it would be taxed if it was sold elsewhere.

Well, after some discussions, particularly with our major aircraft manufacturers, who do take long-term paper, we found that while they had in the past disposed most of it to the banks, they were now beginning to dispose of some of it to pension funds and insurance companies.

Well, that was perfectly all right. It made no difference to our balance of payments. So we changed that provision so they could continue to do that. I don't think that will affect the effectiveness of the tax at all.

Senator DOUGLAS. One more question.

Senator SMATHERS. Yes.

Sure, go right ahead.

Senator DOUGLAS. Earlier, Mr. Secretary, you minimized the possible abatement or avoidance of the taxes by American banks making long time loans rather than issuing securities. But when the total figures came out they seemed to me to indicate a steady increase in the volume of these long time loans abroad, I wonder, therefore, whether your informal estimate that there has only been roughly a 5-percent leakage is really true?

Secretary DILLON. I think it is. This is really a different phenomenon and I think probably a parallel phenomenon to the increase in the demand for portfolio capital from this country, because the very large rise in actual bank lending operations of this nature commenced maybe in March of 1963 before there was any thought of such a tax as this, and then it continued and it was actually even larger in the fourth quarter.

We don't know the details of that, but we do know the details of all these loans since that time and we have analyzed them in detail.

It shows the kind of borrower they are made to, what they are made for, and so forth. It seems clear that a very small precentage, if any, were directly of the type that would otherwise clearly have come to the market for longer term loans.

A great many of them were made to Japan which I think, as I have said before, has gone through a sort of cycle, and they were in the cycle of heavy borrowing through the first quarter of this year. In the second quarter this year, in the months of April and May, there have been no further increase in those loans to Japan, and so it looks like that cycle is coming to an end. This has been very important in its effect on the overall totals, but it has been running for more than a year and, I think, had to do with a deterioration which manifested itself about the same time in the Japanese balance of payments because their prices began to go up. They have since then taken restrictive measures in Japan to hold them down.

Senator DOUGLAS. Couldn't this be in the future a significant measure of avoidance of the basic act?

Secretary DILLON. That is the reason after consideration—it was not in our original submission—later in the fall of last year we submitted to the Ways and Means Committee a suggestion for a manda-

tory detailed reporting provision for banks. That is in the bill as passed the House, and we think it is very important.

The reporting so far has been voluntary, but I daresay the fact that mandatory provisions are in the bill made the voluntary reporting more complete, and easier to obtain, and I think it is very important that that provision stay in the bill. It will give us the information should it appear that a change is necessary, and we have stated—I stated in my statement, and I repeat it here—that should it become apparent that there is any significant direct substitution we would certainly not hesitate to ask for appropriate legislation.

Senator DOUGLAS. Well now, that raises a question as to whether the suggestion of the Senator from Tennessee was not very appropriate in dealing with this matter, to include within the bill standby powers so that you could exercise these powers by administrative order subsequently should they seem necessary.

Do you have any opinion on that?

Secretary DILLON. We haven't thought that would be necessary, but as I said, if the committee felt strongly that was advisable, we wouldn't see any reason to object.

I don't see how we logically could.

Senator DOUGLAS. Just as a matter of curiosity, have you moved on this subject by administrative order prior to the passage of this bill?

Secretary DILLON. No; there was no way we could. We worked out procedures under the bill. We worked out principles for the banks on this reporting procedure on a voluntary basis, which would be virtually identical to what would be required on a mandatory basis under the bill. So, it is already running.

We worked out procedures with the New York Stock Exchange and with the American Stock Exchange for transactions in securities on those exchanges. We worked out with the National Association of Security Dealers the methods of trading in outstanding securities over the counter so it is workable, and functions easily.

These were things that they evolved, and which would be in conformity with the bill when it is adopted and we agreed were proper. They are operating under that mechanism, but we didn't issue any orders.

We havent's issued any orders. We can't until the bill becomes law.

Senator DOUGLAS. And the powers are retroactive under the provisions of the bill.

Secretary DILLON. We haven't operated under the bill at all, but worked with these people either to suggest amendments to the bill when necessary or in an administrative way to work out forms that would work with the bill under the retroactive provisions you point out.

Senator DOUGLAS. Perhaps I should be more secular in my questioning.

Secretary DILLON. Yes.

Senator DOUGLAS. Have your powers of persuasion been increased by the retroactive provisions of the bill?

Secretary DILLON. Very much.

Senator DOUGLAS. That is all. Thank you.

Senator SMATHERS. Senator McCarthy, do you have some questions now after contemplating the bill?

Senator MCCARTHY. Yes.

Mr. Secretary, do any of the European countries use a device similar to the one we are proposing here to control the outflow of capital?

Secretary DILLON. No; all of them except Germany previously have various forms of control. But they have all had complete controls and have gradually moved away from them, and they have more strict governmental controls than we do.

Germany is the only one, I think, that doesn't have such controls legally on their books.

Senator McCARTHY. What devices do they use—capital issues, committees——

Secretary DILLON. They generally have direct governmental approval of issues. They also have situations, such as in England, where, if you sell a foreign issue, you get a different kind of sterling which sells at a different rate in the market from ordinary sterling, and you transfer that to something else and it carries with it the right to buy another foreign issue.

Senator McCARTHY. Have those devices been reasonably successful as they have been used in other countries?

Secretary DILLON. Yes; they have been reasonably successful.

Senator McCARTHY. I wondered why your statement was so firm on how devices of that kind would not be workable if used in the United States?

Secretary DILLON. I don't say it would not be workable at all. I would like to say all the European devices are government operated, government controlled. None of them are of this voluntary nature. I am clear that a voluntary program, because of the complex pressures on those running it, just would not be able to work. I don't see how it would be possible when in 1 day they might have to decide between a loan to build a refinery in Austria and a subway in Berlin and a project in southern Italy and a fertilizer plant in France, how a voluntary group could decide which one—and they could only admit one—they would admit.

Now, if it was run by the Government, of course, it could work. I just say we feel it is preferable not to go a route which in our history we have not done, although it has been done in Europe, except in wartime. We thought that our approach, allowing the market to function freely with this tariff, if you will, upon securities, was a better solution, more in accordance with our traditions.

If it doesn't work, certainly a direct governmental control could be made to work.

Senator McCARTHY. I wondered what your opinion would be as to the advisability of more direct control if the amount of the loan exceeded a certain magnitude, a hundred million dollars or $200 million or $300 million.

Secretary DILLON. Well, very few issues are of that size. I think one of the problems that you would run into—say you set the limit at a hundred million dollars—and I can think of only two or three foreign issues of that size to take place in this country within the last few years—I don't quite know how it would work because nothing would prevent a borrower from taking it in two or three different bites and, therefore, getting under the amount, and——

Senator McCARTHY. Unless it was corporate?

Secretary DILLON. Even then he could do one $50 million issue and then wait 4 months and say "I changed my mind and I need another $50 million." He would come in and you wouldn't have any control of him.

Senator MCCARTHY. To what extent do you think that the improvement may be due to what has happened in the European economy in the last 9 months and what has happened to our economy?

Secretary DILLON. I think, as I pointed out to Senator Bennett earlier, in the case of outstanding equities, outstanding stocks, there have been two things at work here. The interest-equalization tax has made the purchase by Americans of foreign stocks from foreigners unattractive as compared to what they could do here. Parallel to that has been the fact that the European economy has been inflationary. They had a price-profit squeeze, if you will. They still make plenty of profit, but nowhere near as much as they did 2 or 3 years ago.

There have been some political developments in Europe which might give some cause for concern to investors, and as a result of that I think one can see a greater volume of American investors selling European securities than had been the case before.

Now, there is nothing in the tax that would encourage someone to sel a European security to a foreigner that he already had—possibly quite the contrary, because once he has done it he can't replace it.

Nevertheless, this selling is something which has continued. So this, coupled with the tax on buying new securities, has led to a rather dramatic switch in trading in outstanding securities. Instead of having an outflow of funds of around $200 million or $250 million a year, we are having an inflow of funds of about the same volume. So it is a difference of over $500 million in our favor.

Now, part of that is due to economic conditions in Europe, but I would imagine it is less than half of that. I would think the rest of the savings, on the borrowings on debt issues, I don't think economic conditions in Europe have had any effect.

Senator MCCARTHY. I think that is all.

Senator SMATHERS. Thank you very much, Mr. Secretary, for a very lucid and persuasive statement.

The committee meets again tomorow at 10 o'clock at which time they will hear the witnesses for the opposition.

We will stand in recess until 10 o'clock tomorrow.

(Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, June 30, 1964.)

INTEREST EQUALIZATION TAX ACT

TUESDAY, JUNE 30, 1964

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Long, Smathers, Douglas, Talmadge, Williams, Bennett, and Morton.

Also present: Arthur Rothkopf, Treasury Department, Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. Andries D. Woudhuysen of the Association of Stock Exchange Firms.

Will you take a seat, sir, and proceed.

STATEMENT OF ANDRIES D. WOUDHUYSEN, PARTNER, BURNHAM & CO., NEW YORK, N.Y., REPRESENTING ASSOCIATION OF STOCK EXCHANGE FIRMS; ACCOMPANIED BY DAVID KLEE, CHAIRMAN OF THE FOREIGN SECURITIES COMMITTEE OF THE ASSOCIATION; JAMES LYNCH, ASSISTANT GENERAL COUNSEL OF THE ASSOCIATION; AND JOHN NEVINS, CASHIER OF MODEL, ROLAND & CO.

Mr. WOUDHUYSEN. Mr. Chairman and members of the committee, my name is Andries D. Woudhuysen. I am a partner of Burnham & Co., a member of the New York Stock Exchange and very active in the foreign securities market.

I am testifying on behalf of the Association of Stock Exchange Firms, a national trade association which represents 600 member firms of the New York Stock Exchange.

I am accompanied by Mr. David Klee, chairman of the foreign securities committee of the association; Mr. James Lynch, assistant general counsel of the association; and Mr. John Nevins, cashier of Model, Roland & Co.

Mr. Nevins and I will divide the testimony and the time allotted to the association; I will testify with respect to the balance-of-payments aspects and the principles underlying the proposed bill, and Mr. Nevins will deal with the administrative problems.

I am testifying in opposition to H.R. 8000 because we believe that the proposed tax is inimical to the best interest of the Nation, inasmuch as it is predicated upon the erroneous assumption that private U.S. capital exports are a principal cause for the continuous deficits in the U.S. balance of international payments.

To take that position is as mistaken as looking only at U.S. commercial imports as a source of capital outflow, without giving consideration to exports as the complement of imports in what we call our trade balance.

PRIVATE U.S. CAPITAL EXPORTS

Private U.S. capital exports are only one side of the sector—capital movements; the other side being the inflow in which income received on foreign investments more than offsets the exports of capital on account of private foreign investments.

From a balance-of-payments point of view, there are no important and unimportant items; each purchase from a nonresident and each service rendered by a nonresident creates an outflow from the United States; each sale or service rendered to a nonresident creates an inflow of money.

While this is perhaps somewhat an oversimplification, it is basically correct; and lack of time prevents me from going any deeper into the subject.

However, there are indeed types of outflow of capital which are more desirable than others. While tourism may be educational and creates better understanding among people, from a balance-of-payments point of view, the tremendous outflow of capital resulting from several hundred thousand Americans spending their vacations abroad represents an outflow of capital which creates very little in terms of return inflow, except to the extent that it may stimulate foreigners to visit the United States (to see the country where all these strange but nice people are coming from), and to the extent that the money spent by U.S. tourists abroad enables foreign countries to increase their imports from abroad, hopefully also from the United States.

Not so with private U.S. capital exports. The return on these capital exports in terms of interest and dividends was estimated to be $3 billion in 1959 and had risen to $4.3 billion in 1962.

I have not had the time, in the few days available to witnesses to prepare their testimony, to check these figures, but they are taken from the late President Kennedy's special message on balance of payments, dated July 18, 1963, to the Congress of the United States, and I am sure they are correct.

Why the Treasury selected this sector of the balance of international payments as a vehicle to redress the deficit is not quite clear, in view of the repercussions which it may provoke for the one area of the balance of payments which not only yields rich returns but actually pays for itself, inasmuch as the income it creates equals or surpasses the outflow it causes.

EXEMPTIONS

The private U.S. capital exports sector of our balance of payments is constituted of the following five categories:[1]

1. Outstanding foreign securities.
2. New issues of foreign securities.
3. Direct investments.
4. Other long-term loans.
5. Short-term loans.

[1] Because of lack of time, and for the convenience of the members of the committee, a more detailed explanation of each of these categories is appended to this statement as exhibit A, for inclusion into the record.

The proposed bill, as it was approved by the House of Representatives, exempts from the tax the categories above referred to under 3 and 5, while it exempts from the tax the long-term loans referred to under 4 above, if such loans are made by a commercial bank in the ordinary course of its commercial banking business.

Since this type of loan is in practice indeed largely extended by commercial banks, and since these commercial banks would normally not extend such loans unless it were in the interest of their commercial banking business, it can be said that category 4 is, for all practical purposes, exempt, although perhaps in theory there may be some loans under this heading which could be subject to the interest equalization tax.

This leaves only two out of the five categories subject to the tax, and these are:

1. Outstanding foreign securities.
2. New issues of foreign securities.

And even these two categories are not invariably subject to the tax because there are a considerable number of exemptions, some of which are very important.

Attached hereto are tables furnishing the statistics by areas and by forms of capital export for the years 1960, 1961, 1962, 1963, and the first quarter of 1964 (exhibits A–1, A–2, and A–3).

In enumerating to what extent even the remaining two categories are exempt from the tax, attention is directed to the fact that in both categories the securities of international institutions of which the United States is a member are excluded from the tax.

Also exempt in both categories are the securities of so-called less developed countries and less developed country corporations. The term "less developed country corporations" applies to corporations organized under the laws of less developed countries and meeting the requirements of section 955 of the Internal Revenue Code of 1954, as amended.

In addition to the exemptions referred to above, the proposed legislation includes provision for the exclusion from the tax of original or new issues where required for international monetary stability.

Under this section, the President may, at any time, determine that the application of the interest equalization tax will have such consequences as to imperil or threaten to imperil the stability of the international monetary system. Under this section of the proposed legislation, the President has already indicated that Canada will be exempt.

While it pleases us that Canada will be exempt from the tax as far as new issues are concerned, it cannot be denied that Canada was the single largest distributor in the United States of "new issues" in each of the years 1960 through 1963, and that this exemption is one reason why the tax applies to less than 10 percent of the total private U.S. capital export.

A glance at the annual totals in the statistics appended to this statement reveals that total private U.S. capital exports during the 51 months' period covering the 4 years 1960 through 1963, and the first quarter 1964, have amounted to approximately $16.2 billion.

It does not require complicated calculations to determine that the following categories are exempt: Direct investments, $7.2 billion; long- and short-term loans, $5.3 billion; leaving subject to the tax a total

of $3.7 billion, representing the two categories "New issues of foreign securities" and "Outstanding foreign securities."

Deducting from these the exemption for Canada and for such areas as Latin America and "other areas," which are exempt because they fall within the category "less developed countries," we have to take another $2.2 billion off so that only $1.5 billion remains, which is less than 10 percent of the total of $16.2 billion.

There are quite a number of other more or less important exemptions, but it would take up too much time to enumerate them all.

Our analysis of the three categories which are exempt and the two categories which are subject to the interest equalization tax, and applying whatever further exemptions have been granted to those two, divulges that no more than 10 percent of the total private U.S. capital exports is subject to the interest equalization tax.

During the 4 years 1960 through 1963, and the first quarter 1964, private U.S. capital exports have amounted to $16.2 billion, and on the basis of exemptions referred to above, one can safely estimate that no more than approximately 1½ billion is affected by the tax.

EFFECT OF EXEMPTIONS

During the testimony before the House Ways and Means Committee in August 1963, several witnesses pointed out that the structure of the capital market is such that by closing off one source of funds, recourse can be had to other sources.

Thus, the ability to obtain financing from sources which are exempt from the interest equalization tax, such as commercial bank loans, will divert new financing from the public securities markets to the commercial banks.

One witness stated there was a real prospect that the bill will have little or no effect in reducing the total outflow of private capital. An added disadvantage to the balance of payments can result from the diversion from the public securities markets to bank loans, because bank loans affect the U.S. balance of payments by the full amount of the loan, whereas public issues are also bought by foreigners.

As a result, $50 million of public financing has a less unfavorable effect upon the balance of payments than $50 million of bank loans to foreigners.

How legitimate this warning was, is demonstrated by the statistics attached to this statement.

A cursory glance at the statistics of long- and short-term loans since the interest equalization tax was effective, in comparison with prior periods, immediately divulges that the effect of the interest equalization tax on the category "New issues of foreign securities" has been completely offset by a sharp increase in the category "Long- and short-term loans."

We are not suggesting that the United States as a source of capital for foreign borrowers should be completely closed off: We are, however, demonstrating that the interest equalization tax has been absolutely ineffective in reducing the capital outflow, and that its only effect has been to divert foreign borrowings from the public securities markets in the United States to the commercial banks.

The statistics for the first quarter of 1964 as compared to the first quarter of 1963, are also appended to this statement, and prove that this shift from taxable sources to tax-exempt sources, from the public securities markets to the commercial banks, is continuing unabated.

VOLUNTARY CAPITAL ISSUES COMMITTEE

Under these circumstances, one cannot but reach the conclusion that a voluntary Capital Issues Committee under the auspices of the Federal Reserve Bank of New York, similar to the one in operation during the Korean war, might be an effective substitute for the interest equalization tax.

A voluntary Capital Issues Committee composed of members of the financial community in cooperation with the Federal Reserve could set up and apply guidelines with respect to the total amount which the United States can afford to lend to foreign borrowers on a quarterly or semiannual basis.

Such a Capital Issues Committee would, of course, be applicable to the category "New issues of foreign securities," and it would not affect the only other category subject to the proposad interest equalization tax, the category "Outstanding foreign securities."

As the attached statistics over a period of 4¼ years clearly demonstrate, this category does not require any safeguards.

Considering the fact that International Institutions, of which the United States is a member, are exempt from the proposed interest equalization tax anyway, and applying that principle to this category, it is established beyond doubt that the United States started divesting itself of foreign securities immediately after 1961—i.e., 1½ years before the interest equalization tax was announced.

As a matter of fact, I had the privilege of attending yesterday's hearing before the committee, during which Secretary Dillion testified, and afterward I devoted some time to studying the statistics attached to his testimony.

Looking at table No. 2, appended to his statement, I find that the Treasury lists separately "New issues," "Outstanding securities," "Redemptions."

Needless to say that the redemptions apply to the outstanding securities, because there can be no redemptions of new issues, and, if we reduce the outflow of capital on account of purchases of outstanding securities by the amounts of redemptions which the Treasury listed separately, we find that the outflow of capital on account of outstanding securities was as follows:

	Millions
1960 outflow	−$108
1961 outflow	−239
1962 inflow	+107
1963 inflow	+189
1964, 1st quarter inflow	+572

With this ineffective tax, the United States is giving away on a silver platter its status as the leading international financial center of the world. It gained this status because London, which had been the primary international financial center, was unable to maintain it as a result of the Second World War.

34-937—64——9

Until the announcement of the interest equalization tax, London never regained its status. Since July 1963, it is well on the way to taking over from New York. This demonstrates how difficult it is to regain international financial prominence, once it is lost.

How many years will it take to regain that prominence for New York, once it has lost its status as the leading financial center of the world as a result of the interest equalization tax?

As one of the actions in his program to reduce the deficit in the U.S. balance-of-payments and defend U.S. gold reserves, the late President Kennedy, on October 2, 1963, appointed a task force on "promoting increased foreign investment in U.S. corporate securities, and so forth." One of the terms of reference of this task force was:

> The identification and critical appraisal of the legal, administrative, and institutional restrictions remaining in the capital markets of other industrial nations of the free world which prevent the purchase of U.S. securities and hamper U.S. companies in financing their operations abroad from non-U.S. sources.

In its report dated April 27, 1964, the task force, under the chairmanship of Henry H. Fowler, then Under Secretary of the Treasury, states:

> No useful purposes would, we believe, be served by making detailed recommendations as to the removal of foreign restrictions or methods by which other countries could improve their domestic capital markets. In each country these matters are often complex and technical; they involve delicate domestic relationships; frequently they transcend financial considerations and encompass national policies well beyond the terms of reference of the task force. It should be noted that efforts to remove restraining influences on sales of U.S. securities to foreigners will raise in foreign financial markets the question of the continuance of the U.S. interest equalization tax as a factor affecting the sales of foreign securities to U.S. citizens, however temporary and special its basis.

It is obvious that this task force, under the chairmanship of the Under Secretary of the Treasury, could not be too critical of the interest equalization tax. But it is equally obvious that it considers the interest equalization tax inconsistent with the administration's desire and efforts to promote increased investments by foreigners in U.S. securities, and as an obstacle thereto.

CONCLUSION

On the strength of the above testimony, the opinion of the Association of Stock Exchange Firms is evident; we respectfully urge the Senate Committee on Finance to conclude that the bill is ineffective and inequitable, and that it should, therefore, not be enacted. If the members of the committee feel that some form of legislation is unavoidable, along the lines proposed by the administration, it should

at least exclude the category "Outstanding foreign securities" from the application of the tax, although the members may well wish to take all the time they deem necessary to study the many ramifications of the legislation in its proposed form and may wish to give serious consideration to a voluntary capital issues committee as a substitute for H.R. 8000.

The CHAIRMAN. Thank you very much.

(The statements referred to follow:)

EXHIBIT A. BRIEF EXPLANATION OF THE FIVE CATEGORIES CONSTITUTING PRIVATE U.S. CAPITAL EXPORTS

The Department of Commerce from time to time publishes these statistics classified by areas and by form of capital, and as far as the different forms of capital are concerned, it distinguishes:[1]

1. *Outstanding foreign securities.*—These are securities issued by foreign corporations and bought by U.S. investors (private and institutional) as portfolio investments. This category is by no means limited to foreign securities listed on national stock exchanges; it includes many hundreds of foreign securities for which an over-the-counter market is made in the United States by certain brokers and dealers. Neither is this category restricted to foreign securities registered with the SEC; more often than not these securities are not registered in the United States, but there is no legal restriction on transactions in these securities by virtue of the fact that they are not newly issued.

2. *New issues of foreign securities.*—These are new issues floated in the United States, registered with the SEC.

3. *Direct investments.*—This is a somewhat loose label generally used for investments by U.S. companies in foreign subsidiaries and for acquisitions of substantial blocks of an equity in one foreign company on the part of one U.S. investor or a group of related U.S. investors, having in mind to acquire an interest in a foreign company. This label does not necessarily mean the acquisition of a controlling interest, and the text of H.R. 8000 dated March 9, 1964, of the interest equalization tax, uses the term "Direct investments" for equity interests amounting to 10 percent or more of the outstanding voting stock of a foreign corporation.

4. *Other long-term loans.*—This category includes long term, that is to say more than 1 year, loans to foreigners or foreign corporations by commercial banks or any other U.S. lender, such as pension funds and other institutions.

5. *Short-term loans.*—The same as the previous category, but maturing within 1 year and largely made by U.S. commercial banks, but in some instances by other U.S. lenders to foreigners. The distinction referred to in this paragraph and in the preceding paragraph between long term and short term used to be one largely determined by the policy of the lender, and in general banks in the United States used to consider maturities of less than 2 years as short term and maturities of more than 2 years as long term. The proposed interest equalization tax exempts from the tax maturities of less than 36 months, so that by virtue of the proposed bill the dividing line between long term and short term is arbitrarily established at 3 years, at variance with the statistical practices followed by reporting U.S. agencies.

[1] Categories 1, 2, and 3 apply to equity securities as well as debt securities, whereas categories 4 and 5 apply practically always to debt securities.

EXHIBIT A-1.—*Total private U.S. capital exports by area*

[Millions of dollars]

	Outstanding foreign securities	New issues foreign securities (net)	Direct investments	Other long-term loans (net)	Short-term loans (net)	Total
1960:						
Europe	−126	1	−962	−13	−423	−1,523
Canada	−94	−109	−451	32	−213	−835
Latin America	nil	−95	−95	−159	−100	−539
Japan and other	−49	−73	−154	−60	−522	−858
Subtotal	−269	−276	−1,662	−200	−1,348	−3,755
International institutions, etc	−40	−78	−12	Nil	Nil	−130
Total	−309	−354	−1,674	−200	−1,348	−3,885
1961:						
Europe	−234	−27	−724	−116	−49	−1,150
Canada	−88	−182	−302	10	−503	−1,065
Latin America	−18	−4	−173	−108	−150	−453
Japan	−11	−59	−29	−34	−695	−828
Other	−51	−109	−303	−15	−169	−697
Subtotal	−402	−381	−1,591	−263	−1,556	−4,193
International institutions, etc	15	6	−8	Nil	Nil	13
Total	−387	−375	−1,599	−263	−1,556	−4,180
1962:						
Europe	−16	−162	−867	−82	−184	−1,311
Canada	79	−374	−314	−37	−64	−710
Latin America	−22	−88	32	−39	−103	−220
Japan	−23	−97	−54	−108	−245	−527
Other	−16	−84	−377	8	48	−426
Subtotal	2	−805	−1,580	−258	−553	−3,194
International institutions, etc	−98	−68	−74	Nil	Nil	−240
Total	−96	−873	−1,654	−258	−553	−3,434
1963:						
Europe	2	−249	−869	−513	−82	−1,711
Canada	81	−629	−334	16	42	−824
Latin America	−1	−17	−63	29	−98	−160
Japan	−29	−131	−68	−114	−440	−782
Other	−5	−59	−489	18	−118	−653
Subtotal	48	−1,085	−1,823	−564	−696	−4,120
International institutions, etc	−54	11	−39	Nil	Nil	−82
Total	−6	−1,074	−1,862	−564	−696	−4,202

Source: Survey of Current Business, June 1964.

EXHIBIT A-2.—*Quarterly private U.S. capital export by area*

[Millions of dollars]

	Outstanding foreign securities	New issues foreign securities (net)	Direct investments	Other long-term loans (net)	Short-term loans (net)	Total
1963 (1st quarter):						
Europe	−17	−63	−403	−28	87	−424
Canada	30	−341	−118	19	−57	−407
Latin America	2	−11	13	−13	78	69
Japan	−10	−12	−13	−22	−12	−69
Other	−2	−15	−33	25	−34	−59
Subtotal	3	−442	−554	−19	62	−950
International institutions, etc	−62	4	3	Nil	−1	−56
Total	−59	−438	−551	−19	61	−1,006
1964 (1st quarter)[1]:						
Europe	66	3	−270	−152	−21	−374
Canada	20	−71	−21	4	−244	−312
Latin America	4	−11	−15	−15	−65	−102
Japan	4	13	−31	−56	−239	−309
Other	2	−21	−73	−13	−61	−166
Subtotal	96	−87	−410	−232	−630	−1,263
International institutions, etc	3	−1	−23	Nil	Nil	−21
Total	99	−88	−433	−232	−630	−1,284

[1] Preliminary.

Source: Survey of Current Business, June 1964.

EXHIBIT A-3.—*Semiannual private U.S. capital exports by area*

[Millions of dollars]

	Outstanding foreign securities	New issues foreign securities (net)	Direct investments	Other long-term loans (net)	Short-term loans (net)	Total
1962 (2d half):						
Europe	32	−10	−371	−43	−213	−605
Canada	40	−274	−201	−13	−10	−458
Latin America	−13	−80	−4	64	−93	−126
Japan	−15	−69	−31	−69	7	−177
Other	nil	−70	−159	61	36	−132
Subtotal	44	−503	−766	Nil	−273	−1,498
International institutions, etc	−10	1	−96	−1	Nil	−106
Total	34	−502	−862	−1	−273	−1,604
Revised totals[1]	28	−493	−943	−14	−316	−1,748
1963 (2d half):						
Europe	54	−35	−324	−343	7	−641
Canada	50	−54	−163	−35	294	92
Latin America	1	−14	−123	51	−143	−228
Japan	−4	−54	−19	−89	−294	−460
Other	14	−16	−173	−2	−89	−266
Subtotal	115	−173	−802	−418	−225	−1,503
International institutions, etc	6	5	−8	Nil	Nil	3
Total	121	−168	−810	−418	−225	−1,500

[1] Revised totals as reported in June 1964. Survey of current business area breakdown was not published.

Sources: Survey of Current Business, March and June 1964.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. No questions.

Mr. WOUDHUYSEN. Mr. Nevins will testify on the operational aspects, with your permission, Mr. Chairman.

Senator BENNETT. Would you prefer that Mr. Nevins testify before we question either or both of you?

Mr. WOUDHUYSEN. I would, Senator Bennett.

The CHAIRMAN. Our time is limited, you know.

Mr. WOUDHUYSEN. I apologize.

The CHAIRMAN. It is understood, I think we can only have one witness but if you would be very brief as we have a number of witnesses and we have to go into the session at 12 o'clock.

Mr. NEVINS. My statement it quite brief.

I am John A. Nevins, cashier of Model, Roland & Co., a member firm of the New York Stock Exchange and an active dealer in foreign securities. I am here as a representative of the Association of Stock Exchange Firms, a voluntary, nonprofit trade association comprised of approximately 600 member firms of the New York Stock Exchange.

The association's membership is nationwide, and many of its members have foreign branches as well. As president of the Cashiers' Association of Wall Street, I am in a position to collect and coordinate a great deal of information relating to the operational problems that would be created for the securities industry by the passage of this legislation, especially with regard to the retroactive information reporting requirements.

As you know, when the interest equalization tax was first proposed last July by the late President Kennedy, the securities industry was suddenly required to create a whole new system of forms, controls, and procedures, not only to assist the Treasury in enforcing this proposed tax but also to inform customers of their obligations under the proposed legislation.

For the past year we have been in the rather inconceivable situation of trying to comply with a tax law that has not been enacted. Only during the last couple of months have some fairly standard procedures been worked out that allow us to integrate this compliance information with customers' records and with records maintained by dealers.

Moreover, some of these procedures will be changed in the near future since the Treasury is planning, upon passage of this bill, to revise the various forms presently in use.

I might add that the Treasury has been extremely cooperative in submitting draft copies of these forms to our industry for comment.

When this legislation was first introduced in the House of Representatives, it did not contain any requirement that brokers supply the Treasury with information as to foreign transactions participated in by their customers. The only returns proposed were the quarterly returns to be filed by persons who incur a liability for the tax.

The bill now before your committee requires information returns from brokers. The Treasury has already announced that these filings will be required quarterly, retroactive to July 19, 1963.

In effect, this provision shifts a great deal of the administrative cost of enforcing this bill on to the shoulders of our industry. Not only will the enactment of this bill have a detrimental economic effect on our business, but now we are being asked to pay for its enforcement.

Since the Secretary of the Treasury has stated that this bill is a temporary excise tax and not a revenue measure, we feel that it is entirely inequitable that our industry should be forced not only to bear the huge expense involved in maintaining the voluminous records required by this bill but also to prepare quarterly information returns.

As has been pointed out, should this bill be enacted, the effective date of it would be July 19, 1963. The Treasury has announced that they will require information returns on all taxable foreign security transactions retroactive to that date.

The compilation of such information on these transactions is an enormous, time consuming and expensive task. The only way firms, whether highly automated or not, could possibly compile this information accurately would be to perform a complete audit of all their foreign transactions of the past 12 months. This could not be accomplished by the use of computers and would require a great many expensive man-hours of work.

A serious question always exists in any of these information return programs as to the effective use of this information by the Treasury.

American business spends untold millions of dollars each year in the preparation of these forms. To require that we now incur any additional burden for what is purported to be a temporary nonrevenue excise tax appears completely unjustifiable.

The problems involved are truly staggering if one considers the absence of standard procedures which existed for many months, the difficulty of determining which transactions are subject to the proposed tax (especially in the area of transactions in corporate securities of less developed countries), the problems of indoctrinating branch office management and sales personnel, and the administrative confusion which existed and continues to exist to a large degree as between dealings in listed and unlisted foreign securities.

In conclusion, I would like to make the following recommendations should the bill receive the further attention of the committee.

1. That the committee revise the proposed section 4920(c) so as to make the effective date of the legislation coincide with the date of the enactment of the bill. In other words, completely eliminate the retroactive nature of this legislation.

2. That the committee completely eliminate the requirement that brokers and dealers file information returns. This would restrict the filing requirement to those taxpayers who have incurred a tax liability.

In the event the committee does not favorably consider these recommendations, we then request that a special current effective date be included in section 6011(d)(3) which would pertain to information returns only.

I wish to reaffirm the strong objection of the Association of Stock Exchange Firms members to H.R. 8000. We offer these recommendations on certain of the points contained in the bill only to point out the overall operational problems that the enactment of this legislation would create. We hope that the committee will call on this association for any further information it may desire.

Thank you.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. I am sure I am going to mispronounce your name.

Mr. Woudhuysen, would it be fair to say that it is your impression that at the expense of making some temporary gain we are making a long-term loss in relation to the balance-of-payments problem and in relation to our status as the center of the international monetary market of the world, capital market?

Mr. WOUDHUYSEN. Yes, Senator Bennett.

I think that is quite a fair statement. The fact that, under the proposed legislation, residents of the United States cannot purchase foreign securities outside the United States unless they incur a 15-percent tax makes it—for all practical purposes—unattractive to buy foreign securities, so that the only corrections which investors who own foreign securities can make is to sell.

The result will be a current erosion of quality and erosion of quality in the total U.S. holdings of foreign securities, with a subsequent reduction in income to the detriment of the balance of payments in future years.

Senator BENNETT. Do you see any weakness in the situation because the bills or the proposed life of the law is more or less indefinite?

Of course, the law is supposed to expire in 1965, but it is one of these temporary laws and nothing is more permanent than a temporary law.

Does this have any effect, psychological effect, on the investor?

Mr. WOUDHUYSEN. Yes, Senator Bennett. There is a general belief, as you expressed it quite correctly, that the chances that this bill will indeed expire at the end of 1965 are extremely slight.

Senator BENNETT. So an investor would rather buy a security whose tax status he can depend on than one whose tax status—the tax status of whose income is uncertain.

Mr. WOUDHUYSEN. Yes, Senator.

Senator BENNETT. Now, I was very much interested in your statement that this bill lets the big fish through and only catches the little ones. That only 10 percent of the capital outflow is affected by this tax, and to arrive at that figure you use a period from the beginning of 1960 through to the present.

What would the figure be if we considered only the records of the last year since this law was proposed?

Would it be as low as 10 percent or higher?

Mr. WOUDHUYSEN. Since the bill became effective the outflow of capital in the two areas which are affected by the bill has, of course, decreased substantially, so that its relationship to the total which has not decreased is affected, and I would say if it has applied only to the period since the bill has been effective, the percentage is smaller than 10 percent.

Senator BENNETT. Would you think it might be as small as 5 percent or have you not done the computations?

Mr. WOUDHUYSEN. We would have to take the second half of 1963, as on exhibit A–3, with a total outflow of $1,500 million, plus the first quarter of 1964, with a total outflow of $1,284 million, so together, $2,784 million. The areas affected are outstanding and new issues which in the fourth quarter rendered a surplus of $11 million, and now I am not, because it would take too much time to make the calculation, I am not taking out Canada, I am not taking out Latin America, and I am not taking out other countries which are exempt.

In the second half of 1963 the outflow was $47 million, so that it leaves an outflow of $38 million for the 9 months in the two categories affected by the tax, and there it would amount to about 1½ percent of the total capital outflow in that 9-month period.

Senator BENNETT. So as a result of this recommendation which has not yet become a bill, we have further narrowed the area subject to the tax until it now represents only 1½ percent or approximately that.

Mr. WOUDHUYSEN. Yes, Senator Bennett.

Senator BENNETT. And 98 percent of the capital is still flowing out?

Mr. WOUDHUYSEN. Yes, sir.

Senator BENNETT. Not stopped by the tax?

Mr. WOUDHUYSEN. Exempt from the tax.

Senator BENNETT. Exempt from the tax.

Let me ask you one further question which has been puzzling me. Is it possible since Canada has an effective, almost total, exemption, for Canada to become a pipeline through which capital can flow to other areas so that the Canadian exemption could become a loophole through which this bill could be pretty effectively negated?

Mr. WOUDHUYSEN. Senator Bennett, I don't think this could be of any material influence, I don't think this would be substantial. Canada could become a channel only if through Canada the securities of other countries were offered to the public in the United States. But since the bill applies to the area in which the securities are issued, I don't think this could be substantial.

Senator BENNETT. You don't think it would be possible to set up some kind of a holding company?

Mr. WOUDHUYSEN. Oh, yes.

There are always ways and means, there is no question about it. There are always possibilities.

Senator BENNETT. So it would be possible for a smart financier, a man trying to get into the American capital market without subjecting his people to the tax, he could probably find a way to use the Canadian exemption as a device?

Mr. WOUDHUYSEN. A non-Canadian company could organize a subsidiary, a holding company or a subsidiary in Canada which, in turn, could float securities which would be exempt from the tax, and the proceeds of any such issue could conceivably be made available to the non-Canadian parent company.

As a matter of fact, I never thought of that.

Senator BENNETT. There is a slight fee, a slight charge for the idea. Those are all the questions I have, Mr. Chairman.

The CHAIRMAN. Senator Morton?

Senator MORTON. Just one question, just commenting on Senator Bennett's calculation you made reducing this from 10 percent to 1 percent the reason is this message did come up here last July 19.

Mr. WOUDHUYSEN. You are right, Senator Morton.

The CHAIRMAN. Thank you very much.

The next witness is Mr. William T. Barnes for the American Research & Development Corp.

Will you take a seat, sir, and proceed.

STATEMENT OF WILLIAM T. BARNES, OF LYBRAND, ROSS BROS. & MONTGOMERY, ON BEHALF OF THE AMERICAN RESEARCH & DEVELOPMENT CORP.

Mr. BARNES. Thank you, Mr. Chairman.

My name is WILLIAM T. BARNES. I am a partner of Lybrand, Ross Bros. & Montgomery and I appear on behalf of our client American Research & Development Corp., of Boston, Mass.

I am accompanied by Mr. Henry Hoagland, vice president of American Research & Development Corp. General Doriot, the president of the company, extends his regrets. He had hoped that he would be here to testify before you but he was in Europe when the message of the hearing dates came out and was unable to return.

I wish to discuss what I believe to be an unintended hardship which will arise from the application of section 4915(c) of the bill as presently constituted.

Direct investments in oversea subsidiaries and affiliates are excluded from the application of the interest equalization tax (sec. 4915(a)).

A "direct investor" is defined as one who owns immediately following an acquisition at least 10 percent of the voting power of all classes of stock of a foreign corporation.

The report of the Committee on Ways and Means states, by way of explanation, that "direct investment implies active participation in the management of the corporation" and further that "decisions to make investments of this type are concerned with questions of market position and long-range profitability rather than interest rate differentials."

However, section 4915(c) of the bill nullifies the exclusion for direct investment if the foreign corporation in which the investment is made is "formed or availed of by the U.S. person for the principal purpose of acquiring, through such corporation, an interest in stock or debt obligations the direct acquisition of which by the U.S. person would be subject to the tax."

The committee report states that the purpose of the above-quoted provision is to prevent U.S. persons from forming "closely held" holding companies for the purpose of acquiring securities which would be taxed if acquired directly.

Our client, American Research & Development Corp. (hereinafter referred to as ARD), was organized under the laws of Massachusetts on June 6, 1946.

It was the first publicly owned venture capital company in the United States.

It was formed to supply capital to help outstanding individuals build companies of stature and to create capital appreciation for the ARD shareholders.

Among its founders were Karl Compton, then president of Massachusetts Institute of Technology; Merrill Griswold, then chairman of Massachusetts Investors Trust; and former Senator Ralph Flanders, then head of the Federal Reserve Bank of Boston.

These men and others recognized the need in America of an organization to supply venture capital to small or new businesses where such businesses were not able to obtain long-term working capital from a bank, insurance company, or from sale of stock to the public.

Since 1954 ARD has qualified annually for special treatment under code section 851(e) as an investment company principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available.

ARD is neither a lending institution nor is it in the securities business. It seeks an equity position or its equivalent in all ventures. The nature of the work done at ARD involves the careful selection of ideas and of men who are able to commercialize them successfully.

Since 1946 it has financed 83 companies. In 35 of these companies ARD has already realized gains, while in 12 it has already realized losses.

When ARD invests in a company, it stays with it through its early years until it can be determined whether the venture will eventually be successful, as is proved by the average of 6.5 years for which it has maintained its investments in those companies originally in its portfolio in which it finally decided to sustain a loss and no longer work with the company.

ARD not only furnishes money to its portfolio companies, it also furnishes consulting services, with members of the ARD staff often serving as directors and even as officers of these companies. Such services have included location of operating personnel, location of plant sites, location of new products, location of customers, location of additional sources of financing, financial planning, and even participation when necessary in operating decisions.

Of course, these services are not required by all of the companies in which ARD makes an investment. Nevertheless, when ARD makes an investment, it is always with the knowledge that it may be called upon to furnish such services, as it has done in the past.

Believing it to be important to extend this concept into the countries of our friends and allies, active consideration commenced late in 1960 of similar operations in Canada and in Western Europe.

The position taken by Gen. Georges F. Doriot, president of ARD, was that the work must be undertaken by people who felt that they were acting constructively for their particular part of the world.

Canadian Enterprise Development Corp., Ltd., was organized in October 1962. ARD holds a minority interest in this company and the remainder is owned by 24 Canadian and 2 British insurance companies and banks.

This corporation is operating in Canada in the same fashion as does ARD in the United States.

More time was required to carry out General Doriot's concept of a broad-based, European-controlled company and to get agreement among the participants regarding its location and organization.

In December 1963, there was organized under the laws of Luxembourg a corporation known as European Enterprises Development Co. (hereinafter described as "EED"). Capitalized at $2,500,000, EED is owned 60 percent by 18 foreign banks and other financial institutions representing 10 Western European countries and 40 percent equally by 4 U.S. financial institutions, including ARD.

General Doriot, president of ARD, is also president and chairman of the board of directors of EED. It is intended that EED will

function in Europe in the same fashion as ARD has in the United States.

It is believed that U.S. enterprises will benefit substantially through cross-licensing of patents and other technology.

It is the investment of the U.S. shareholders in EED which creates the problem at hand. It is submitted that the interest equalization tax should not apply to these direct investments because:

(1) EED was conceived long before there was any discussion of the tax and its formation had developed to the point that 75 percent of the capital ultimately provided by U.S. sources and 78 percent of the capital provided by European sources had been pledged to the undertaking before July 18, 1963, the date of President Kennedy's message to the Congress.

(2) There will be active participation by the U.S. shareholders, particularly by ARD, in the management of EED.

(3) EED will not be in the "securities business." Not only is that not its mission, but also there will be little market for the stocks in which it will invest until the then struggling company has become well established and prosperous, if that time ever comes. This is a venture which counts on long-range accomplishment—not on a quick turnover. Moreover, a substantial part of EED's activity will consist of furnishing management assistance to its portfolio companies.

(4) EED's investments generally will be either in stock constituting more than 10 percent of the voting power of all classes of stock of the particular company or in equivalent amounts of convertible indebtedness. Where the medium of convertible debt is utilized, the interest rate will equal or exceed prime bank rates in that particular country.

I offer the following facts in support of the above-stated reasons. Active discussions with American and European banking interests commenced during the summer of 1961.

Essential to the undertaking from the beginning has been the inclusion of traditional European capital sources in order to accustom their financial managers to the concept as well as the techniques of furnishing true venture capital to small, untried companies.

In order to influence substantial European financial institutions into participating in EED, it was initially found advisable to include Morgan Guaranty Trust Co. of New York, through its Edge Act corporation, Morgan Guaranty International Finance Corp., and Lehman Bros. as participants, since they were names well known in European financial circles.

(Later, the Continental Illinois National Bank & Trust Co. of Chicago, through its Edge Act corporation, Continental International Finance Corp., also indicated its willingness to participate in the venture.)

At the same time, these U.S. investors were willing to participate only if General Doriot directed EED's activities in a manner similar to that in which he had directed ARD's activities in the United States.

The board of directors of ARD authorized its participation in this venture on October 11, 1961, almost 2 years prior to the President's message, to an extent substantially greater than the amount ultimately invested by ARD.

A partner of Lehman Bros. notified General Doriot on October 17, 1961, that his firm would invest a specified amount which was greater than the amount ultimately invested.

An officer of Morgan Guaranty Trust Co. wrote to General Doriot on July 27, 1962, stating that they would participate in a specified amount which was greater than that which was ultimately invested by Morgan, as well.

Thus, 75 percent of the capital ultimately invested by U.S. shareholders had been pledged to the undertaking a year prior to the President's message proposing the interest equalization tax.

Discussions with the fourth U.S. shareholder were begun several months prior to July 1963, and not finalized until after, but this shareholder's decision to participate was in no way motivated by the President's message.

Moreover, ARD requested an opinion from the Securities and Exchange Commission on March 13, 1962, and received a reply on August 7, 1962, permitting ARD to acquire stock in EED.

The delay until December 1963, in incorporating EED was caused by the desire that a majority of its stock be owned by European interests and by the time required, in the light of this desire, to obtain the necessary capital from and agreement among the European participants.

It is abundantly clear that EED was not formed for the purpose, principal, or otherwise, of avoiding the interest equalization tax. It is equally clear that it will not be availed of for that purpose.

Yet it appears that, without amendment, section 4915(c) will be applied as follows:

ARD owns 10 percent of EED. If EED acquires a 20-percent interest in a European venture, ARD has a 2-percent beneficial interest in such venture. Had ARD acquired a 2-percent interest in such venture directly, such acquisition would have been subject to the tax. Therefore, this line of reasoning would go, ARD's original investment in EED is subject to the tax. This is without regard to the fact that ARD, had it chosen to do so, could have established a wholly owned subsidiary to carry out this activity with no imposition of the tax whatever and also that it could make directly any of the 10-percent investments which EED will make with no imposition of the tax, but because of the conduct of the separate corporation this result would seem to obtain.

This harsh result can be prevented, either by expanding the rules presently governing preexisting commitments or by providing an additional exception to the "formed or availed of" rules of section 4915(c).

The first approach could be effected by adding the following to section 2(c)(2) of the bill. This would be preceded by:

Such amendments shall not apply to an acquisition * * *

(E) of capital stock which would have been excluded from tax under section 4915 of the Internal Revenue Code of 1954 but for the provisions of subsection (c) thereof, if on or before July 18, 1963, the acquiring U.S. persons (or, in a case where two or more U.S. persons are making acquisitions attendant to the initial capitalization of a corporation, at least 75 percent in interest of such persons) had signified to the person coordinating the organization of such corporation the intention to invest a specified amount of money through the purchase of such stock, which specified amount was equal to or greater than the amount ultimately so invested.

The second approach could be effected by adding the following to section 4915(c)(1):

This subsection shall not apply in cases where:

(A) The foreign corporation is principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available;

(B) Substantially all of the foreign corporation's investments are in stock constituting at least 10 percent of the combined voting power of all classes of stock of the issuing corporation, or in equivalent amounts of convertible indebtedness which is treated as stock under section 4920(a)(2)(D);

(C) The foreign corporation's activities consist in substantial part of the furnishing of management services to the corporations in which it invests; and

(D) The investments of U.S. shareholders in such foreign corporation are sufficiently large that individually they could have made direct acquisitions of the requisite 10 percent of the stock of any of the issuing corporations.

I appreciate very much the opportunity to speak to you.

We will now be glad to respond to any questions that you may have.

The CHAIRMAN. Thank you very much, Mr. Barnes.

Any questions?

Senator BENNETT. Just one.

Which of the two approaches would you prefer?

Mr. BARNES. I have no choice, sir. I think that the second approach is the more restrictive.

Senator BENNETT. Yes. It applies specifically to your company.

Mr. BARNES. Yes, sir. The first is restrictive in that it would apply only to a 10 percent investment situation in the first place and only to the initial capitalization of a corporation in the second place.

Senator BENNETT. Do you know of any other corporation that is caught in this same squeeze?

Mr. BARNES. I know of none in the same posture as we are. There are only three 851(e) companies in the United States. The other ones are relatively small and do not have foreign operations.

Senator BENNETT. No further questions.

The CHAIRMAN. Senator Morton?

Senator MORTON. No; I think Mr. Barnes made a good point and I have no questions.

The CHAIRMAN. The next witness is Mr. Henry Kearns of the Chamber of Commerce of the United States.

Take a seat, sir.

STATEMENT OF HENRY KEARNS, APPEARING ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES; ACCOMPANIED BY DON BOSTWICK, KEARNS INTERNATIONAL; AND JOHN DONALDSON, STAFF, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. KEARNS. Mr. Chairman and members of the committee, my name is Henry Kearns. I am appearing here today to present the views of the Chamber of Commerce of the United States and on my own behalf as president of Kearns International, a California corporation engaged in the development of private business undertakings in international trade and investment throughout the Orient.

I am a member of the chamber's foreign commerce committee. I am accompanied by Mr. John Donaldson of the national chamber staff and Mr. Don Bostwick of Kearns International.

The interest equalization tax proposal now before your committee constitutes an encroachment both on the principle of freer exchange of international trade and investment, and on the orderly conduct of international commercial transactions.

It does not merit the approval of the Congress.

The very introduction of the original bill as drafted by the Department of the Treasury last summer was a move dangerously close to the imposition of exchange control on the people of the United States who are committed to following a traditional course toward freer international flows of capital and goods.

We have relaxed our own trade barriers, negotiated reciprocal tariff reductions and encouraged the formation of international bodies such as the World Bank and the International Monetary Fund.

When we have been the target of discriminatory restrictions by other nations, we have protested vigorously. From this standpoint alone, the interest equalization tax is totally out of character.

The national chamber, however, is not opposed to the interest equalization tax solely because it violates established national policy. We recognize that our balance-of-payments position needs strengthening, and have been searching diligently for positive solutions. But this proposal will not, in the long run, accomplish that purpose.

During consideration of this tax by the House Ways and Means Committee last August, the national chamber submitted a statement to that committee which said in part:

> The proposed tax would almost certainly not improve the Nation's balance of payments significantly and might even worsen it.

The goal of the tax is to reduce the flow of capital from the United States to other nations. In the long run, U.S. investments abroad bring home far more dollars than are invested initially.

In the long run, our balance-of-payments position, if the tax accomplished its purpose, would suffer, probably severely.

The bill as passed by the House of Representatives contained exceptions and exemptions which in themselves show that the original Treasury proposal was ill-conceived, impractical, and, if enacted, would deter seriously this Nation's foreign commerce.

Additional evidence of the fallacies of the proposal has been provided by the Treasury Department itself in a series of amendments to its original proposal which were submitted to this committee just 2 weeks ago by the Department.

The House bill with its improvements, and as it might be improved further by the Treasury amendments and other Senate changes, partially deodorizes a measures that already has poisoned the atmosphere of international investment confidence.

But even with all of the changes now under consideration, this is not responsible legislation.

The most that proponents of H.R. 8000 can hope for is that it will bring a temporary improvement in our balance-of-payments deficit at the cost of a long-term weakening of our position. We doubt the bill will achieve even this limited and shortsighted objective.

There are three possible results of the tax: (1) Foreigners may continue to market their issues in the United States, paying still higher nominal interest rates in order to attract American capital;

(2) Foreigners may market securities, which otherwise would have been marketed in the United States, in their own or other foreign countries; and

(3) The total amount of foreign securities issued may decline.

To the extent that foreigners continue to market their issues in the United States, paying still higher interest rates, there will not be even a short-term improvement in the U.S. balance-of-payments position.

To the extent that foreigners continue to market securities, but not in the United States, our balance of payments might improve temporarily. But it is likely that in a very short time, most of the effect of the tax will be wiped out by interest rate adjusments here and abroad.

The first effect of the tax would be to reduce the differential between U.S. and foreign interest rates. But if foreigners market their securities abroad, U.S. capital would tend to stay at home, pushing U.S. interest rates down.

Conversely, the increased demand in foreign capital markets would push foreign interest rates up. The rise probably would be substantial, since all indications are that foreign capital markets are insufficiently developed to satisfy a large rise in the demand for funds.

To the extent that there is a decline in the total amount of foreign securities issued, both here and abroad, our balance-of-payments position again might conceivably improve in the very short run. But the longer term reaction would offset the short-term improvement.

A decline in the amount of securities issued would lead to slower growth rates abroad, slower capital formation, and thereby a deterioration in our balance of trade.

The deterioration in the trade balance, of course, would be the result of lower foreign incomes leading to declines in foreign purchases of our goods. Also, lower foreign growth rates would make it significantly more difficult for U.S. goods to compete in price, since the rate of price increase abroad almost positively would decline.

It is significant to note that recent history supports these conclusions. When H.R. 8000 was initially proposed, almost a year ago, we witnessed a modest improvement in our capital account.

Now, however, the thin, false veneer of effect has worn off. Because the tax would be retroactive, it is unlikely that the actual enactment of the bill would have any effect at all on our capital account.

Whatever temporary improvement of the threat of the legislation may have caused, the fact is that such limited improvement, if any, already has occurred. The actual enactment of the bill would only weaken our long-term payments position.

A further danger is that historically any government's imposition of restrictions on international commerce generally is greeted with reciprocal actions or retaliation.

During my service as Assistant Secretary of Commerce for International Affairs, I was able to show, in testimony before the House Committee on Ways and Means, the close correlation between private investment abroad and our country's exports.

No figures available since that testimony refute the evidence that American investment in foreign countries stimulates exports in a near equal proportion.

Moreover, we must remember that the balance-of-payments account is only a method of recording receipts and payments in international transactions. While investment abroad in any one year is shown on those accounts to be a payment, or expenditure, such payment definitely does not, in fact, represent a liability.

Quite to the contrary, these payments actually can be considered an increase in this Nation's net worth, for Americans own that investment and, importantly, receive dividends on that investment as well as retain the right to repatriate that investment itself.

The effect this tax would have on foreign confidence in the dollar must also be considered. Proponents of the tax have asserted that it will improve confidence in the dollar overseas.

But there is serious doubt that foreigners can respect the U.S. Government's response to our balance-of-payments difficulties when that response is as weak and flexible as H.R. 8000.

Further, since its introduction, the interest equalization tax proposal has, in effect, had a most adverse effect upon important segments of the economy related to international business.

In consideration of your limited time, I shall confine my remarks to the effects this proposed legislation has had upon relations between the United States and Japan, where my company, Kearns International, has had considerable experience.

The effects H.R. 8000 either is likely to have or in fact already has had on Japan include these:

1. The proposal and threat of legislation has affected adversely private capital formation in Japan by its severe impact on the Japanese securities markets, and thus has seriously inhibited Japan's economic development during the past year.

2. H.R. 8000 would reduce Japan's ability to aid in the development of southeast Asia through public and private entities.

3. H.R. 8000 has weakened the economic ties between Japan and the United States, and has resulted in Japan taking a more receptive attitude toward trade with and economic overtures from the Soviet Union and Communist China.

4. H.R. 8000 seriously reduces the confidence of Japanese private and public figures in this country's long-term intentions toward their country.

5. The legislation, through its deterrent effect in establishing useful economic ventures between the United States and Japan, has reduced tax-producing income for American investors.

In the course of our operations in Japan, I maintain frequent consultation with important executives of Japanese business. I can report to you with accuracy that these Japanese, many of whom are warm friends of the United States, are deeply concerned about both the effects of the proposed legislation and the attitude it reflects.

The present tight-money policy which is restricting the economy of Japan is a direct result of the interest equalization tax proposal.

It was my privilege to serve as a member of the American delegation to the third United States-Japan Businessmen's Conference cosponsored by the national chamber in Tokyo last month. The Japa-

nese delegation was unanimous in its opinion that the proposed legislation is the most important matter affecting economic relationships between the two countries. The American delegation was urgently requested to take every possible step to secure exemption for Japan from the legislation.

Attached as an appendix to this testimony is a list of the names and identification of the Japanese delegation to that joint conference. Their affiliations illustrate the high executive level and broad industry representation of the Japanese delegation.

It emphasizes the opinion of the Japanese business community that the interest equalization tax legislation is most damaging to Japan and thereby affects seriously Japan-United States relations.

Where my company develops business arrangements between the United States and Japan, investment and loans are frequently the major factor. We have analyzed the use to which the American capital going to Japan has been put.

I can state with assurance that very little outflow of capital results from these business arrangements. Usually the capital is devoted to payment for imports of goods from the United States, payments for American services and know-how, and to maintain credits in the United States for use by the Japanese.

Your committee is well aware that Japan is America's second largest oversea customer, having purchased more than $2 billion of U.S. goods in 1963. This amounted to about a third of Japan's total imports. The committee is aware also, of course, that we Americans, annually, sell to Japan about $500 million worth of goods more than the Japanese sell to us.

The imbalance in trade between our two countries is responsible largely for Japan's keen surveillance of its own balance-of-payments situation.

With their problems, they have managed to maintain some stability in their gold reserves, amounting to a total of $279 million in 1959 and 1960, and $304 million in 1961, 1962, and 1963.

The Japanese Government's gold and foreign exchange holdings have declined almost steadily since last October, however, and this has created considerable resentment toward the United States in knowledgeable Japanese circles.

The amount involved here, I believe, can illustrate to the committee the insignificant effect upon our gold flow of the Japanese transactions in this field.

The Japanese have exercised restraint in not purchasing gold in the United States in recent months and it is understandable that they expect reasonable restraint on our part in not upsetting their precarious position.

Your committee is well aware, too, that Japan is the foundation on which American influence in the Orient rests. Without Japan as a close and friendly ally it would probably be impossible for the United States to maintain an effective position of leadership and influence in the Western Pacific area.

Your committee is well aware of the great importance Japan must place on ever-increasing business activity, and that Japan is a capital-starved nation.

Without access to sources of capital from the United States the continuing industrial development of Japan will be slowed; its influence for Western-type development in the Far East will be reduced; and the burden of economic development of the developing countries of southeast Asia will rest more heavily upon our country.

I am sure you are well aware, Mr. Chairman, that we are making strenuous efforts to encourage Japan to aid the underdeveloped countries. They can only do so if they have the foreign exchange capability of maintaining those activities.

Allow me to emphasize these points, Mr. Chairman; the interest-equalization tax proposed is ill conceived. The interest-equalization tax will not improve this country's balance of payments in the long run.

To the contrary, the proposal, if enacted, would worsen our balance-of-payments position. The interest-equalization tax, if enacted, would hurt—indeed the very proposal has hurt our position of confidence in Japan and elsewhere.

And speaking for Kearns International, let me urge that you establish unmistakably your opposition to the imposition of this tax on American investment in Japan.

The national chamber's opposition to H.R. 8000 does not mean a lack of concern over our balance-of-payments problems. There are steps which can and should be taken; other avenues which should be explored.

The national chamber has established a new international monetary problems subcommittee to review and explore long-range solutions.

It is essential that Federal spending abroad—particularly in the military field and in Europe—be held to a minimum commensurate with our national interest. Because tourist expenditures by Americans overseas last year almost equaled our total payments deficit, much more should be done to attract foreign visitors to our shores.

A presidential task force headed by Treasury Under Secretary Fowler recommended last month that foreign sales of U.S. securities should be substantially increased if our structural payments imbalance is to be overcome.

Included in the Fowler report were such recommendations as—

(*a*) Allowing interest rates on time deposits to be flexible, thus making U.S. banks competitive with foreign banks;

(*b*) Reducing U.S. income and estate taxes and eliminating complex U.S. tax provisions;

(*c*) Encouraging foreign sales of U.S. securities partly by urging U.S. underwriters to float issues abroad and by urging U.S. companies with oversea subsidiaries to sell shares to foreign employees; and

(*d*) Persuading foreign nations to lower barriers to sales of U.S. securities abroad. The report also recommended U.S. assistance to help develop capital markets abroad.

In spearheading the export promotion drive which was proposed to the Congress on March 17, 1960, by President Eisenhower, I stressed the facts of life in our balance-of-payments situation, noting that we must either cut outgo or raise income. We felt then, and I suggest you consider now, the solution to our balance of payments lies in increasing income, and cutting out unnecessary expenditures rather than cutting out revenue-producing endeavors.

These are the kind of positive, forward-looking steps we need—not the hesitant, fearful retreat toward exchange controls which is embodied in the interest-equalization tax proposal.

Therefore, we earnestly recommend that this committee not approve H.R. 8000.

Mr. Chairman, I will be happy to submit to any questions.

(The attachment referred to follows:)

REPRESENTATIVES OF THE JOINT COMMITTEE ON JAPAN-UNITED STATES TRADE

Taizo, Ishizaka, president, Federation of Economic Organizations.
Tadashi Adachi, president, Japan Chamber of Commerce & Industry.
Heitaro Inagaki, president, Japan Foreign Trade Council, Inc.
Masao Anzai, president, Showa Denko, K. K.
Toshio Doko, president, Ishikawajima Harima Heavy Industries Co., Ltd.
Toyonobu Domen, president, Ajinomoto Co., Inc.
Katsuhiko Hamaguchi, chairman, Japanese National Committee of ICC; president, Kokusai Denshin Denwa Co., Ltd.
Masaru Hayakawa, managing director, Japan Federation of Employers' Associations.
Teizo Horikoshi, executive director, Federation of Economic Organizations.
Shinobu Ichikawa, president, Marubeni-Iida Co., Ltd.
Hiroki Imazato, president, Nippon Seiko, K. K.
Yoshihiro Inayama, president, Yawata Iron & Steel Co., Ltd.
Yoshizane Iwasa, president, Fuji Bank, Ltd.
Fumio Iwashita, president, Tokyo Shibaura Electric Co., Ltd.
Ekizo Kashu, president, Japan Chemical Textile Association; chairman of the board, Mitsubishi Rayon Co., Ltd.
Katsuji Kawamata, president, Automotive Industrial Association; president, Nissan Motors Co., Ltd.
Shige Kawata, chairman of the board, Japan Steel Tube Co., Ltd.
Hajime Mase, managing director, Japan Machinery Exporter's Association.
Kunio Miki, managing director, Bank of Tokyo.
Hikoichiro Miyazaki, vice president, Japan Foreign Trade Council, Inc.; head Kansai office, Japan Foreign Trade Council, Inc.
Kanichi Moroi, representative director, Federation of Employers' Associations; president, Chichibu Cement Co.
Kenichiro Komai, president, Hitachi, Ltd.
Takashi Komatsu, vice president, American-Japan Society.
Takashi Murayama, managing director, All Japan Cotton Spinners' Association.
Shigeo Nagano, president, Japan Iron & Steel Federation; president, Fuji Iron & Steel Co., Ltd.
Teiichi Nagamura, vice president, Japan External Trade Organization.
Taneichiro Nakano, president, Kyoto Chamber of Commerce and Industry.
Yasutaro Niizeki, chairman of the board, Mitsui Bussan Kaisha, Ltd.
Ichiro Nozaki, counselor, Nozaki & Co., Ltd.
Daizo Odawara, president, Osaka Chamber of Commerce and Industry; president, Kubota Iron & Machinery Works.
Saburo Ohta, managing director, C. Ito & Co., Ltd.
Arakazu Ojima, vice president, Federation of Economic Organizations; chairman of the board, Yawata Iron & Steel Co., Ltd.
Tsunao Okumura, chairman of the board, Nomura Securities Co., Ltd.
Masao Onishi, managing director, Taiyo Fishery Co.
Takashi Rinoie, president, Yokohama Chamber of Commerce and Industry; chairman of the board, Mitsubishi Steel Co., Ltd.
Hiroshi Sakai, managing director, Japan Wool Spinners' Association.
Kiichiro Sato, vice president, Federation of Economic Organizations; chairman of the board, Mitsui Bank, Ltd.
Takeshi Sakurada, president, Nisshin Cotton Spinning Co., Ltd.
Michisuke Sugi, president, Japan External Trade Organization.
Kyoichi Suzuki, president, Nagoya Chamber of Commerce and Industry; president, Tokai Bank.
Hajime Takagi, managing director, Japan Chamber of Commerce and Industry.
Shinichi Takasugi, adviser, Mitsubishi Electric Mfg. Co., Ltd.

Masatoshi Tanibayashi, managing director, Japan Foreign Trade Council, Inc.
Ichiro Terao, senior managing director, Mitsubishi Shoji Kaisha, Ltd.
Tadashi Tsukasa, vice president, Tokyo Chamber of Commerce and Industry; president, Maruzen Co., Ltd.
Kogoro Uemura, vice president, Federation of Economic Organizations.
Katsumi Yamagata, chairman of the board, Yamashita Shin-nihon Shipping Co., Ltd.
Hatsujiro Yoshida, counselor, Japan Wool Spinners' Association, adviser; Daito Woolen Spinning & Weaving Co., Ltd.

The CHAIRMAN. Thank you very much, Mr. Kearns.

Any questions?

Senator DOUGLAS. I came in late, so I think the other members should have a first chance. Therefore, I will waive my turn temporarily.

Senator BENNETT. Mr. Chairman, I would just like to ask Mr. Kearns: Was there any noticeable public or official reaction in Japan when it became obvious we were going to make an exemption for Canada but had refused to make a similar exemption for Japan?

Mr. KEARNS. Senator Bennett, we try in our business to maintain constant surveillance of economic news by reviewing the Japan business publications.

There was immediate notice of it, what was interpreted by the Japanese as an agreement to exempt Canada; and the Japanese—I can't say that officially, but the trade journals representing the business community, were very forceful in their views that Japan as the second largest customer, as the bulwark of our whole structure in the Far East, deserved no less treatment than would Canada.

I can say from private conversations that there is considerable resentment over the fact that Japan, in their view, has been discriminated against in this case.

Senator BENNETT. To use the old wornout phrase: Did we cause the Japanese people to lose face as a result of this decision?

Mr. KEARNS. Well, they lost money and that hurt them. I don't know which hurt most, their losing face or money, but it upset their plans for development. I would say yes; this would be a difficult thing, but I think that the flow of investment concerned them more.

Senator BENNETT. I am very interested in the first comment you made to the effect that when this became known it destroyed or it weakened the faith of the Japanese people in their own security market for their own internal securities.

Do I interpret that statement of yours correctly?

Mr. KEARNS. Yes, Senator Bennett. The Japanese securities market dropped severely upon the announcement of the request for the legislation. I happen to have one——

Senator BENNETT. That was put in the record yesterday, that figure of——

Mr. KEARNS. Yes. In the view of the Japanese exchange or securities people, the market has never yet recovered. It is like a 99-percent business that can't operate on 99; it has to have 100 percent. The expectation of investment from the United States, and the flow of capital from the United States were just enough to upset the balance, and to date the Japanese securities market is still in the doldrums, a year later, and the experts tell us that this is due to the threat of the legislation.

Senator BENNETT. No other questions, Mr. Chairman.

The CHAIRMAN. Senator Morton?

Senator Douglas?

Senator DOUGLAS. One question.

I have the impression that you gave general approval to the reduction of economic and military aid. Is that correct?

Mr. KEARNS. A reduction of Federal oversea spending, including military spending, to the extent that it is in the interests of this country, yes.

Senator DOUGLAS. That is the point.

Would you favor reduction in military aid to the Chinese Government on Formosa?

Mr. KEARNS. I have no knowledge of the amount of military aid to China.

Senator DOUGLAS. Would you favor reduction of military aid to South Korea?

Mr. KEARNS. Senator Douglas, I have no knowledge of how much military aid goes to any one country. I am not privy to that classified information.

Senator DOUGLAS. You have made a recommendation and inasmuch as the chamber of commerce is one of the most influential organizations in the United States, we have to take into account its various suggestions. I am trying to find out just specifically what you are proposing.

Mr. KEARNS. I was expressing here the position of the Chamber of Commerce of the United States and I would like to call on John Donaldson who is on the staff of the chamber to express its position.

Senator DOUGLAS. Well, take specific countries, such as Korea, the Chinese Government on Formosa, South Vietnam, and Laos. Do you favor a withdrawal from South Vietnam and Laos?

Mr. DONALDSON. Senator Douglas, the national chamber supports foreign economic and military assistance. We do not recommend withdrawal from southeast Asia. In our consideration of aid appropriation requests each year, we try to give as specific recommendations as possible.

We do not go into a country-by-country breakdown but rather a line item breakdown of the budget requests.

Senator DOUGLAS. Do you favor reduction in the total amount of military aid?

Mr. DONALDSON. No, sir.

Senator DOUGLAS. You do not?

Mr. DONALDSON. No, sir.

The national chamber has supported and testified in both the House and Senate this year in favor of the full $1 billion original military aid request.

Senator DOUGLAS. Do you favor a reduction in economic aid?

Mr. DONALDSON. In certain categories; yes, sir.

Senator DOUGLAS. Where?

Mr. DONALDSON. Mainly in the categories of supporting assistance, contingency funds, and grants. We support in full the requests for development loans and Alliance for Progress loans, also for multilateral programs and international institutions such as the Inter-American Development Bank and International Development Association.

Senator DOUGLAS. Did you say supporting grants?

Mr. DONALDSON. I beg your pardon, sir?

Senator DOUGLAS. Did you say supporting grants?

Mr. DONALDSON. Supporting assistance.

Senator DOUGLAS. These terms seem to change from year to year so it is good to be clear.

Mr. DONALDSON. This, as you know, was the old defense support category, which is termed economic aid given to countries where we are trying to maintain a certain military balance.

In some instances the chamber has felt that this aid has not always been used for the proper purposes.

Senator DOUGLAS. Do you have specific instances of that?

Mr. DONALDSON. There have been instances brought to our attention.

Senator DOUGLAS. But you have mentioned them?

Mr. DONALDSON. Yes, sir. We would be glad to supply them for the record.

Senator DOUGLAS. I would appreciate it if you would, because these general principles have to be translated into concrete actions and the difficulty is always when you try to apply the principles to specific situations.

Mr. DONALDSON. We agree with you completely, Senator, on that.

(The information referred to follows:)

SUPPLEMENTAL STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES IN RESPONSE TO THE REQUEST OF SENATOR DOUGLAS

The Chamber of Commerce of the United States has testified its concern over the use of so-called economic aid for other than long-range economic development purposes, and sponsored amendments to the Foreign Assistance Act to strengthen statutory prohibitions against such unintended usage. Specifically, the chamber has protested the granting of supporting assistance for alleged economic development in payment for military base rights. If U.S. military security requires assistance of this type, the chamber has urged that it be budgeted in the military assistance program, and not masqueraded as economic development. Such practices under the program finally have been ended in Spain, but continue in such countries as Jordan, Morocco, and Trinidad-Tobago.

The chamber also questions the use of economic development funds for "internal security" programs financed through supporting assistance. There is little doubt that such countries as the Congo, Laos, Vietnam and Korea are in need of internal as well as external security measures. But the chamber questions the use of allegedly economic aid to maintain civilian police and military construction programs in some countries in Latin America or such countries as Thailand and Yemen.

Finally, with respect to supporting assistance, the chamber believes that some recipient nations progress from total dependence on grants to a degree of self-support has been greater than is reflected in the budget requests for supporting assistance grant aid. Conditions in Korea, Jordan, and Thailand, for example, would seem to justify relatively greater self-reliance and a more expeditious shift from such grants to development assistance, as was possible in Taiwan, Greece, Turkey, and Iran. It seems questionable why $18 million is required in fiscal year 1965 to complete a $30 million defense support program in Burma for which funds were committed in fiscal year 1959.

The above situation also holds true, in the chamber's view, with respect to technical assistance or development grants. The shift from grants to loans should be faster, and in a greater number of instances technical assistance should be effected through private rather than Government channels.

With respect to contingency funds, the chamber regards this category's designation as economic aid as a misnomer. Military emergencies and natural catastrophies which the fund is designed to meet (e.g., the Chilean earthquake, the Lebanon or Suez crises) can be, have been, and should be met through specific, direct requests to Congress, rather than through a large, unidentified, and unidentifiable contingency fund.

Senator DOUGLAS. Would you favor a reduction of American tourists visiting in Europe?

Mr. KEARNS. Senator Douglas, I would rather take a positive view of that. I believe that much more can be done to encourage foreign tourists to visit this country, which brings in foreign exchange. I believe that we have only scratched the surface, particularly of the more prosperous areas of Europe, and now some of the other parts of the world. I would much rather take a positive view on that rather than a restrictive view.

Senator DOUGLAS. Well, the Department of Commerce is trying to encourage foreign tourists to visit this country. In what ways would you suggest that they improve it?

Mr. KEARNS. Well, we made, in 1960, a good number of recommendations on this, and a good many of them have been carried out.

I believe that there is an improvement taking place gradually as a result of these efforts. I am not familiar with the total program today. I do, in my travels abroad, though, consult with people from other countries, and very few people really understand some of the more economical tour arrangements that can be made in this country. I believe, for one thing, that these could be brought to the attention of people who can travel to the United States under present conditions.

Senator DOUGLAS. I have talked with some of the Europeans who have come here, and what they complain about are the high hotel rates. They say that they are really priced out of traveling by these rates. Would you favor a reduction in hotel rates?

Mr. KEARNS. Well, I doubt very much whether this could be accomplished, although as you know, hotel rates run all the way from $4 a night to $10.

Senator DOUGLAS. They never run as low as $4.

Mr. KEARNS. Well, there are some.

General DOUGLAS. You are describing hotels I have never been able to find. I doubt if you would find them.

Mr. KEARNS. To give you specific answers would take more study than we have given to this particular aspect. I firmly believe it would be profitable to do so.

Senator DOUGLAS. It is always easy to lay down general principles. It is very hard to implement them.

Mr. KEARNS. The one thing, the one principle, we would like to emphasize, however, is that you don't solve the problem by eliminating or reducing your sources of income, and the proposal before your committee does, in effect, reduce the future sources of income. You cannot avoid that. If you reduce the outflow you will reduce the inflow over a long period of time.

Senator DOUGLAS. Yes, now that is just the point.

Did you hear or read Secretary Dillon's testimony yesterday?

Mr. KEARNS. Yes; the reports in the papers.

Senator DOUGLAS. Do you remember the point which he made that if one bought a billion dollars of foreign securities, this meant an immediate claim of the foreign countries against us of a billion dollars? Assuming earnings of 5 percent, which is a rather liberal earning, this would mean that in the first year the earnings would only be $55 million, so that while ultimately there would be a paying proposition, in the short run, and for a period of years, there would be a drain upon the

total claims of the United States against other countries. To this degree the purchase would give to the European banks and central banks added power with which to start a run on gold. They love to mention this possibility very delicately, but unmistakably, so as to both keep us on tenterhooks and get us to adopt their ideas of interest rate policies, and the rest.

Mr. KEARNS. Senator Douglas, I differ with the Secretary's contention on that, and I point to the relative amount of inflow that is now coming into this country as a result of investments over the years.

Senator DOUGLAS. But that is past investments.

Mr. KEARNS. The past will catch up with us in the future.

Senator DOUGLAS. Yes, in the future but not immediately. You have studied differential calculus, haven't you? You remember the DX is not the same as X. Changes in DX are not the same as in X.

Mr. KEARNS. That is true, if you can look at this picture on purely a short-run basis, you might be able to make a case——

Senator DOUGLAS. That is right.

Mr. KEARNS (continuing). For that aspect of it.

Senator DOUGLAS. That is right.

Mr. KEARNS. Disregarding all of the other effects. But in the long range——

Senator DOUGLAS. I don't think the Secretary has made anything other than a short-term case. I think he openly admitted that in the long run that foreign investments will yield more income to this country than the immediate outflow in capital, but he emphasized that it would take some years for this to happen.

Mr. KEARNS. Well, personally, I think it is preoccupation with looking at some of the European countries in which probably the Treasury Department has had intimate dealings.

Actually, there is ample evidence to show that foreign investment carries with it an increase in American exports. We have presented testimony to this effect. I don't think it has ever been refuted, and largely the investments of American money abroad actually come back in the sales of American goods. There are few exceptions.

Senator DOUGLAS. Is this made a tie-in condition for the purchase of securities? I mean, for example, when a New York bank and security house subscribes to the purchase of foreign securities, do they demand as a quid pro quo that a portion of this money be invested in the purchase of American machinery?

Mr. KEARNS. Well, in many cases this actually happens.

Senator DOUGLAS. Do they?

Mr. KEARNS. I think, yes, in some cases they would.

Senator DOUGLAS. It would be very valuable if you had some illustrations.

Mr. KEARNS. It would be good as a principle but it would not be wise to tie this as an overall requirement.

Senator DOUGLAS. Do you know it happens?

Mr. KEARNS. Yes.

Senator DOUGLAS. Can you prove it happens?

Mr. KEARNS. Yes.

Senator DOUGLAS. Would you produce such proof?

Mr. KEARNS. I can't in Europe but I can for the Orient where we have some competence; yes, sir.

Senator DOUGLAS. Well, perhaps this might be true for the Orient but remember that in Western Europe, Germany, for instance, has a large capital-building set of industries which are very powerful, both economically and politically.

Mr. KEARNS. Well, I have no competence in these intricate dealings in Europe, but I do have some in the Orient.

Senator DOUGLAS. I wondered if the members of the staff associated with you have illustrations that they would supply for the record so far as Europe is concerned?

Mr. DONALDSON. We would be glad to try to give you some examples.

Senator DOUGLAS. Would you supply those for the record?

Mr. DONALDSON. Yes, sir.

Senator DOUGLAS. Thank you, Mr. Chairman.

(The information referred to follows:)

ADDITIONAL STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, IN RESPONSE TO THE REQUEST OF SENATOR DOUGLAS ON H.R. 8000

The chamber has contacted a number of member companies and commercial lending institutions for specific examples which would serve to illustrate the beneficial effects of private U.S. investment in Europe on U.S. exports and balance-of-payments position. These companies and institutions understandably were reluctant to disclose details of transactions which might violate confidential client relationships. Nonetheless, without exception, those contacted stated that a large number of their financial transactions involving U.S. purchases of foreign securities in fact were predicated on the basis that the proceeds of such loans and investments would be used for the procurements of U.S. goods and services. Equally as often, according to these sources, such transactions stipulate that funds may not be used in certain other countries (such as Communist-controlled countries). The chamber was informed by one institution contacted that the Federal Reserve was kept fully informed of its transactions of this nature and this contact suggested that should the committee desire to investigate further into the public responsibility of financial institutions and the effects of their dealings overseas on the balance of payments, the Federal Reserve would be an initial point of inquiry.

Senator BENNETT. Mr. Chairman, may I come back for just a minute.

The Senator from Illinois has been questioning you about reductions in foreign aid, military or economic. Were you in the room, either of you yesterday, when the Secretary testified?

He made a statement and then he and I exchanged in some discussion. He made the statement that this was a temporary program merely to take care of the situation until the reduction in Government expenditures could take its place, and he said that within this calendar year the Federal Government expected to reduce our expenditures abroad by the rate of a billion dollars a year.

He didn't talk about foreign aid but he talked about—and these are his words:

> The greater part of that was in reduced military expenditures. Those were all scheduled on largely deployment of support troops and closing various installations abroad some of which have already taken place and others of which are definitely scheduled and orders have been issued and they will be taking place in the next 6 months. When we get to the end of the year they will all be in effect. All have been done and my feeling is that we will meet the billion dollar total.

So, when you are testifying about the importance of reducing Government expenditures abroad, were you thinking entirely in terms of foreign aid?

Mr. KEARNS. I was reflecting in that part of the testimony the views of the chamber, which certainly does not single out foreign aid for reductions in Federal spending abroad. Development loans and military aid are tied largely to procurement in the United States, and therefore do not contribute significantly to our payments deficit. There are direct U.S. military savings, burden-sharing and other measures recommended by the chamber.

I personally have had considerable observation of some of the American expenditures abroad and do believe there are many cases in which economies could be effected without any damage to this country.

Senator BENNETT. Well, apparently it is a firm part of the present administration's program to reduce expenditures in the public sector abroad and they have set a goal of a billion dollars a year and say when they achieve that goal it probably will be possible for them to phase this particular tax out of the law.

So, while you may have differed on the question of where the money was to come from, you were apparently in agreement with Secretary Dillon that the public sector must take its share of the responsibility for correcting this imbalance, and they have assumed, and have that responsibility and have a program which they hope will achieve it.

Mr. KEARNS. That is most laudable.

The CHAIRMAN. Thank you very much, Mr. Kearns.

The next witness is Mr. N. R. Danielian, International Economic Policy Association.

Take a seat, sir, and proceed.

STATEMENT OF N. R. DANIELIAN, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Mr. DANIELIAN. Mr. Chairman, I appreciate this opportunity to appear before the committee.

The International Economic Policy Association consisting of a number of U.S. corporations engaged in worldwide trade and investment operations is naturally interested in the effect of the proposed legislation upon the operations of its member companies.

A careful study of the pending bill has shown us that it will not materially affect their present operations. The group as a whole has no position either for or against this measure. From our point of view it must stand on its own merits as a means of helping the United States to allay in some measure the continuing and persistent balance-of-payments deficits.

Since our member companies have no position on this issue I appear here in my personal capacity as an economist to comment on the policy implications of this measure. It is an expression of a prevailing opinion in official circles here and in Europe that the way to solve the U.S. balance-of-payments deficit is to control the flow of private capital.

This was the original purpose of the foreign source income tax proposals in 1961 and it is the basic assumption in the proposed legislation.

I would like, therefore, to address myself to this fundamental question: Is it in the economic interest of the United States to encourage or discourage investment by U.S. companies and individuals in enterprises in foreign countries?

Since the U.S. policy already assumes that investment by U.S. private citizens in underdeveloped countries is desirable and the present legislation exempts investment in, and security issues by, underdeveloped countries, then the more specific question is: Is it in the United States' interest to encourage or discourage investments in developed countries?

Ever since 1958 the United States has been running an annual balance-of-payments deficit of between $2 and $4 billion a year, in spite of the fact that the commodity export surplus has been between $4 and $5 billion per year.

It is generally known that the basic reasons for this balance-of-payments deficit are to be found in our military and foreign aid expenditures.

Military expenditures are estimated at over $3 billion per year.

Foreign aid expenditures, including economic aid administered both by national and international agencies, plus Public Law 480, are close to $4 to $5 billion a year.

It is not necessary in the comparison between export surpluses and military and foreign aid expenditures to make allowance for 100-percent U.S. procurement under Public Law 480, and for 78-percent U.S. procurement, as at present, under foreign aid, because the export surplus figure includes aid-financed exports, as well as exports paid for with the military dollars spent abroad.

The outlays of the U.S. Government for foreign aid and military expenditures require in effect the transfer from the United States to other countries of about $7 to $8 billion worth of goods and services annually.

The commodity export surplus is simply not large enough to accomplish this enormous task. The significance of the balance-of-payments deficit is that we are not succeeding in effecting this transfer in terms of goods and services, and that part of our expenditures are accumulating in the form of claims against us—liquid liabilities.

Attempts have been made to reduce this spread by nonrecurrent temporary devices, such as prepayment of debts by other countries, prepayment on military supply contracts, and, lately, by Treasury and Federal Reserve short- and long-term borrowings abroad.

The foreign aid and military expenditures of the Government are by and large nonrepayable, certainly not within a reasonably short period to affect the balance of payments.

In most cases foreign aid dollar loans extend to 40 years with no interest, at least during the first 10 years. Hence, they are outflows with no present and doubtful future prospects of return.

Outside of the governmentally induced outflows of capital and expenditures abroad, there are, of course, a myriad of private transactions—each one of which affects the balance-of-payments equation, plus or minus, depending upon whether they earn foreign income for us or cause an outflow of dollars.

Imports and exports of goods are the largest identifiable items. The balance has been generally in favor of the United States but not enough to pay for the governmentally induced expenditures.

There are also sales and purchases of services. This is a minus item in our balance to the tune of about $1.4 (1963) billion a year net, primarily because of tourist expenditures abroad which now approach $3 billion a year and cause in themselves a net loss of $1.6 billion.

In addition, there are private capital movements. In 1962 and 1963 capital exports ranged approximately $3.1 to $3.7 billion net. Of this, only about half was in direct private investments, the rest being new issues and portfolio investments.

As compared with private net capital exports, there has been investment income of $3.3 billion (net after paying out income on property and securities owned in the United States by foreigners).

Thus, if you equate the outflow of private capital investments with income thereon, this sector of our international transactions has little effect on our balance of payments—certainly not as much as tourism nor as much as Government expenditures for military and foreign aid purposes.

Yet economists in Europe and some in the United States have fallen into the statistical habit of pinpointing private investment abroad by U.S. citizens as one of the primary causes of the U.S. balance-of-payments deficit.

They put this item at the tail end of their statistical tabulations, as if it was a residual and causative factor in our deficits, and point to it as the villain of the deficit. It could just as easily be said that our private investments abroad are self-sustaining. If there were no investments at all in other countries and no income was received therefrom our balance-of-payments deficit would be just as great as it has been. One cannot say this of Government expenditures. If they were eliminated, we would not have a deficit, but a surplus.

Please note that I am not arguing for the elimination or reduction of these Government programs. These are matters of military and political consideration. I am merely trying to isolate the economic causes of the payments deficit. Whether proposed remedies resolve this problem will depend on whether they touch the causes or merely deal with the symptoms.

Let us then continue our analysis. Income on private investments abroad is one of the largest sources of earnings of the United States.

The United States has approximately $60 billion private investment abroad on which the annual gross return is about $4 billion. In 1963 it was $4.2 billion and the net return after paying foreign investors in the United States, about $3.3 billion.

The usefulness and contribution that his income on investment makes to our balance-of-payments income cannot be denied. It is said, however, that this is true in the long run but not in the short run when the capital outflow makes a definite minus impact upon our balance of payments.

But the future of our balance of payments is assured by increasing this source of income. To achieve this we must allow capital exports on private account to take place wherever the rate of return is highest.

If we could expand our investments abroad from $60 to $100 billion, we might receive as much as $6 or $7 billion a year in investment income. This is possible, as investments mature into profitable projects. This would be a welcome contribution to our ability to maintain foreign aid and military expenditures abroad into the indefinite future, if that should be necessary.

Next, the point must be made that, from a balance-of-payments point of view, investments in hard-currency developed countries are preferable, for two reasons: security of principal and repatriation of earnings are assured, which is not the case in many other parts of the

world; and these are the countries, together, which have the balance-of-payments surpluses.

They are also the ones which have been accumulating liquid assets in the United States and therefore can afford to pay interest and dividends on U.S. investments without hurting their own payments position.

It is not justified, therefore, to look upon private investments in developed countries as if it is one of the least desirable applications of dollar expenditures abroad.

On the contrary, by the continuance of investments in developed countries, we would be making a permanent contribution to our future balance-of-payments position.

This cannot be said for many other expenditures abroad, such as tourism, which is dollars out of hand without return. The idea that a private citizen by investing $100 in an income-bearing security in Europe, which might return $6 a year in dividends, is acting against the public interest; whereas, as a tourist, if he threw away $100 at a gambling casino or in a nightclub, both without return, and for dubious pleasure, is consonant with the U.S. public interest, indicates a topsy-turvy set of priorities. Frugality is bad; conspicuous consumption, good.

Economists, particularly in Europe, put the former—private capital investment—at the bottom of their statistical tabulation, as mentioned before; pinpoint it as the causative factor in deficits and advocate its control.

On the other hand they put tourism and trade at the very top, and consider them sacrosanct from interference. There are many logical reasons for this attitude on the other side of the ocean, but they do not apply to the United States. There is no time to elaborate on them in this statement.

Military and political considerations introduce noneconomic factors affecting priorities in the application of our foreign exchange earnings. Certainly, no one would wish the outposts in the defensive perimeter of the United States to be torn down purely for balance-of-payments reasons.

The British did this, after World War II, but then they knew that the United States would step in to man the posts. We have done this in the Mediterranean, Middle East, and the Far East. But if we withdraw, there is no one else who is as capable or willing to step into the breach as we have.

I am not suggesting here that we dismantle our free world political and military defenses in favor of allowing private investments. I am suggesting, however, that we have not established a rational priority list in the application of our foreign exchange earnings when we continually pick upon private investment as the scapegoat for the correction of balance-of-payments deficits.

The lack of fundamental understanding of the importance of invisible earnings, such as interest and dividends, as it affects our balance of payments, is further emphasized by the fact that as a national policy, in addition to discouraging U.S. investments in developed countries, we are now encouraging foreign investments in the United States to create an inflow of capital.

Recently, we even have set up a Presidential Task Force to advise on how to encourage foreigners to invest in the United States, even to the extent of giving them tax advantages denied a U.S. citizen.

Although temporarily this may bring in an inflow of foreign capital to be invested in U.S. securities, it means that in the long run we shall have to pay interest and dividends to foreign investors, a minus factor in U.S. balance of payments of the future.

Again a paradox—U.S. portfolio investment in Europe is bad; European portfolio investment in the United States is good, athough the first would bring us income and the second would require us to pay out dividends and interests.

In a more fundamental sense, the policy of encouraging the sale of U.S. capital assets to foreigners, in stocks, bonds, businesses, real estate, means that the Government is proposing to finance current deficits caused by political and military necessities by the sale or transfer of ownership of a portion of our property, because our current export earnings are not enough to pay for these current expenditures.

This is like the improvident head of a family, who, unable or unwilling to control his current deficit, the excess of his expenditures over his income, decides to liquidate gradually his income-bearing assets to meet his current deficits.

To the extent that this officially sponsored movement is successful, we will have to pay annual interest and dividends on these foreign investments. As time goes on our ability to bridge the gap in balance-of-payments deficits will become harder and harder.

No European economist or government would propose, as a national policy, the sale of capital assets to meet either current consumption requirements or current political expenditures abroad.

The only time I recall this being done was at the beginning of World War II when England had to sell some of its capital investments in order to finance the earlier phases of the war, before we came to her aid with lend-lease.

Since then, through the Marshall plan and other aid projects, she has recouped a large part of her investments in this country. To acquire assets abroad and earn an income on them is a centuries-old objective of European policy.

In the 100 years after 1816 Britain imported almost £1.7 billion sterling more than she exported. Almost 70 percent of the deficit was met by dividends and interest from foreign investments. Between 1880 and the beginning of World War I, France imported almost Fr25 billion more than she exported, but a revenue of Fr30 billion on return on investment for the period more than made up this deficit.

Likewise, Germany covered 87 percent of her trade deficit between 1894 and 1913 through returns on oversea investment.

I am not proposing that we make it difficult for other countries to invest in the United States because we have to pay dividends and interest to them. What I am suggesting, however, is that we should stop looking at the private investment account as the cause of the balance-of-payments deficit and we should allow capital to flow where it can get the highest return for the United States. If U.S. rates happen to be higher, then U.S. capital will remain here and outside capital will come in.

It has been my contention that the cause of the U.S. balance-of-payments deficit is the necessity of unusually large transfers of wealth from the United States to other countries for military and political reasons; and that we must not expect the ordinary international pricing mechanism and existing exchange rates to carry the burden of this huge unilateral transfer problem.

Any attempt to bring about a redistribution of this burden by classical means such as higher interest rates, import restrictions, and artificial limitation of capital flow, will inhibit the best utilization of resources and therefore conflict with orderly economic development.

None of the measures proposed heretofore resolve the basic problem—how to transfer $7 to $8 billion worth of wealth from the United States to other countries for military and economic aid reasons.

As long as this necessity continues, we shall have a balance-of-payments problem, unless our earnings abroad—the export surplus and income on foreign investments—increase sufficiently to offset this outpouring of expenditures.

Of these two, income on foreign investments, is, in my view, the more promising in the long run. It is difficult to understand therefore any proposal to limit capital investments in hard-currency countries; it is equally difficult to understand how we can help ourselves by selling part of our property to foreign investors.

The burden of defending the free world has fallen in large part upon the United States, requiring a historically unprecedented enterprise of transferring gigantic amounts of wealth from the United States to other countries.

This cannot be done by juggling interest rates, tax rates, exchange rates or tariffs or quotas. It must be accomplished by a sharing of the budgetary burden among the developed countries and eliminating its impact on exchange rates and commercial pricing mechanisms.

The initiative taken by President Johnson in trying to persuade our NATO allies to share in these obligations is the best hope. The next task that remains for American policymakers is to persuade our allies that this is in their interests as well, because the consequences of not sharing in these burdens, may be possible recession in the United States or inflation and bust in the European countries.

The loss resulting from such developments would be much greater than the annual budgetary burden if the expenses of the free world defense were reasonably divided among the countries of the Atlantic community.

In presenting this point of view, I do not wish to belittle the valiant efforts made by our Government to control the payments deficits. Secretary of Defense McNamara and AID Administrator David Bell are to be commended for the aggressive initiative they have taken to control Government expenditures abroad.

The Treasury Department's attempts to stabilize the dollar's exchange value by a series of ingenious moves have been brilliantly executed. The growing cooperation among the central banking community since the gold crisis of 1900 is a great achievement of financial diplomacy.

All these extraordinary programs have gained us time, but they have not eliminated the problem. The solution of this is political; not financial or economic.

The CHAIRMAN. Thank you very much, sir.

Any questions?

Senator DOUGLAS. I have a question, Mr. Chairman.

Mr. Danielian, as you know, I have been a great admirer of yours since I read your famous and somewhat amusing article "From Insult to Injury," which the Atlantic Monthly published, as I remember it, about 30 years ago. That was when you were the foremost advocate of the St. Lawrence Seaway. I have come to admire both your brilliance as an economist and your argumentative skill, and I find myself in general agreement with the conclusions to which you come on page 14 of your statement; namely, that the European countries should assume a larger share of the burden of our common defense.

But I wonder if in your great skill you have not somewhat overstressed your case in the preliminary pages of your testimony, and therefore I would like to raise two matters for your consideration.

You say:

> Foreign aid expenditures, including economic aid administered both by national and international agencies, plus Public Law 480, are close to $4 and $5 billion a year.

Then you have a slight disavowal. You are not saying there is 100-percent U.S. procurement under Public Law 480 abroad.

Is it not true that the distribution of surplus stocks under Public Law 480 is a case in which the expenditures are entirely within the United States and where the commodities themselves are shipped overseas, thus not occasioning any appreciable American expenditure to foreigners?

Mr. DANIELIAN. Senator Douglas——

Senator DOUGLAS. So why don't you strike Public Law 480 out of this list?

Mr. DANIELIAN. First, I want to say that I appreciate your kind comments. I have been an admirer of yours for as many years, and I hope, in some measure, I have tried to emulate your brilliance in economic analysis, as a junior student of the subject.

Senator DOUGLAS. We seem to pass compliments back and forth. [Laughter.]

Mr. DANIELIAN. I must say, however, that perhaps you misunderstand the comparison. I was comparing here the $5 billion in commodity surplus with the $8 billion of military and foreign aid expenditures.

Now, it so happens in the statistics of $5 billion of commodity surplus, Public Law 480 exports are recorded as exports.

Now, you can compare it in two ways, you can either compare the $5 billion with the $8 billion or you can compare the net cash surplus which is closer to $2 billion with, say, $5 billion, by eliminating the domestically procured exports.

So, that this is purely a question of statistical comparison.

Senator DOUGLAS. Public Law 480 does not, however, create claims of the foreign countries against us.

Mr. DANIELIAN. Excuse me?

Senator DOUGLAS. Exportation of wheat and cotton and other articles under Public Law 480 does not give rise to foreign claims against us.

Mr. DANIELIAN. That is true. But here I am making a comparison to show the net deficit in our commodity account as against our

Government expenditures. The $5 billion in commodity surpluses includes Public Law 480 exports, and also foreign aid financed exports. This amounts to about $2.7 billion out of the total.

So, you can compare it this way, as I have done, or you can compare it by just eliminating the $2.7 billion from the $5 billion commodity export surplus and say we only have $2.3 billion in surpluses to meet military and aid expenditures of about $5 billion plus and then you can eliminate Public Law 480 and U.S. financed exports under foreign aid.

Senator DOUGLAS. Now, you say that we get a return of $4 billion of interest and dividends on $60 billion of private investment abroad, and net return after paying foreign investors in the United States of about $3.3 billion.

This would make the interest and dividends on foreign investments in the United States only about $700 million a year. Yet later on you properly note that foreign investments in the United States have been increasing recently.

Is this figure of $700 million accurate as of this day?

Mr. DANIELIAN. Well, I can only rely upon the Government statistics in presenting——

Senator DOUGLAS. That is the best source that I know of.

Mr. DANIELIAN. The Survey of Current Business, and also all other statistics on this subject give a net figure of $3.3 billion as the investment return to the United States as against gross return of $4.2 billion, so that it would be in the range of $700 to $900 million a year of reverse payment on investment account to other countries.

Senator DOUGLAS. What do you estimate the volume of foreign investment in the United States to be annually?

Mr. DANIELIAN. I do not have that figure. I will be glad to supply that to the committee.

(The following was later received for the record:)

According to the balance-of-payments figures in the June 1964 issue of the Survey of Current Business, following are the annual net figures of the total investment by foreigners in the United States for the period 1960 through the first quarter of 1964. These figures represent the total net increase of foreign capital invested in:

(1) Direct investments in the United States.
(2) Other long-term investments.
(3) U.S. private short-term commercial and brokerage liabilities.
(4) U.S. Government liabilities other than interest-bearing securities.
(5) U.S. Government nonmarketable, medium-term, nonconvertible securities.

[In millions of dollars]

1960	366
1961	707
1962	1,030
1963	710
First quarter 1964	102

During the period 1960 through 1963 the average annual net volume of investments by foreigners in the United States was $703 million.

According to the August 1963 issue of Survey of Current Business, as of December 31, 1962, the total cumulative foreign assets and investments in the United States was $47,368 million. In 1961, it was $46,878 million, and in 1950, it was $18,407 million.

Senator DOUGLAS. Now, you have certain moralistic comments with which I find myself in a good deal of sympathy about tourists throwing away a hundred dollars in a gambling casino or a nightclub in Europe

Have you thought of any ways of providing for more ethical expenditures by tourists abroad?

Mr. DANIELIAN. I think this is a political question, Senator. I have a feeling that we are trying to escape the politically hard decisions in this balance-of-payments situation and that is one of the reasons why we pick on private investments because as a constituency it is not as powerful as the number of tourists who want to go to Europe.

Senator DOUGLAS. Would you suggest putting a limit on total expenditures for a tourist as most of the European countries do?

Mr. DANIELIAN. If I were driven to a hard choice I would establish a set of priorities for the expenditure of U.S. dollars abroad and I would say that tourist expenditures would be near the bottom. I am talking about a national set of priorities.

If we come to the conclusion that expenditures, say, for balance-of-payments reasons to Brazil or Argentina or some other country is more important than allowing freedom of U.S. tourists in Europe, then as a matter of national policy, I think we should have the courage to make that decision.

But we shouldn't really play around the issue as we have been for the last several years now, and we should face up to the facts of life.

Senator DOUGLAS. You have mentioned Monte Carlo by implication.

What about the Uffizi in Florence, the Louvre in Paris, the Dahlem Museum in West Berlin, the Mount St. Michel at Chartres and the National Gallery in London—aren't these European attractions ones which enhance the real cultural life and deepen the spirit of the United States?

Should you toss these aside and center your denunciation simply on Monte Carlo and the gambling casinos of the effete Europe?

Mr. DANIELIAN. Well, you are raising a very difficult question of judgment as to what percentage of our tourists are really culturally inclined and I have no statistical evidence on that subject.

But I must say that what we confront in the present situation is that we have to tighten our belts, both internally and in a budgetary sense by taking so much of our income to devote to defensive purposes; if we are willing to tighten our budget to the extent of paying taxes to do this, then what we are really doing is giving up some of our own domestic, consumption requirements to maintain our foreign aid and military expenditures.

When you put these expenditures in the category of a sacrifice to be made for the defense of the free world, then it would seem to me that the sacrifices will have to be determined on the basis of the collective judgment of Congress.

You may want to take the difficult task of separating the cultural ambitions and the more amusement-inclined tourists and set up standards on that. I doubt very much that that would be practical.

Senator DOUGLAS. But on the whole, you are willing to reduce the cultural enhancement of the United States as well as the gambling proclivities of the United States in an effort to maintain material balance, is that right?

Mr. DANIELIAN. Material balance in our balance of payments?

Senator DOUGLAS. Yes. You seem to wish to make commodities rather than culture the standard of life.

Mr. DANIELIAN. I think not.

Senator DOUGLAS. All right.

Mr. DANIELIAN. When the United States decides to tax its people to the tune of $7 or $8 billion in order to support this effort it has made a very great decision of sacrifice for its people. It has taken it out of the people's standard of living obviously.

Now, in that, too, there are certain priorities as every family has priorities. Certainly education would not be the least important application of our resources, so I would say I would not consider educational expenses as dispensable in this set of priorities.

Certainly educational development of this country is just as important as its technological and material development.

Senator DOUGLAS. Now, you come, I think, to your major recommendation which is that our allies should assume a larger share of our international burden.

I find myself in general agreement with this. I have been trying to get the figures on military expenditures. As I now understand it, we roughly spend 10 percent of our gross national product on military expenditures including atomic energy. Isn't that about right?

Mr. DANIELIAN. Yes, about that.

Senator DOUGLAS. And the average for the European countries is approximately 5 percent. Isn't that true?

Mr. DANIELIAN. It varies from 5 to 7 percent in different countries.

Senator DOUGLAS. With a higher income per person you would expect some progression, due to the greater ability to pay. But I think your general contention that England, France, and Germany should provide a larger proportion of their gross national products for common defense is correct. I think this needs to be stressed very much.

Now, I had thought the same condition, more or less, applied in the field of economic aid. I have just been reading, however, a very able book by Frank Coffin, a former Congressman who is, I think, now Deputy Director of AID. He is a very level- and hard-headed fellow.

Frank Coffin advances some figures showing that if you take loans into consideration, the percentage of gross national product which the major European countries give overseas is as great as ours.

Have you gone into those figures at all?

Mr. DANIELIAN. Yes; I have studied the foreign aid program in fairly great detail. On that particular point, I must say that we are really adding up horses and rabbits.

Senator DOUGLAS. Horses and what? Rabbits?

Mr. DANIELIAN. Yes.

The Europeans make hard loans, 5 to 7 years at 5 or 6 percent. There are exceptions. I think the exceptions are increasing but the amounts of the exceptions are not very large.

And of course, they get their annual interest paid and their money.

Senator DOUGLAS. Rather high interest rates, are they not?

Mr. DANIELIAN. Yes, rather high interest rates, and I suspect that those loans would not be made except for the fact we are willing to advance to the same countries no-interest loans. The security of European investments is thus fairly well assured because we make these no-interest balance-of-payments loans to these countries.

Now, to me that does not show a comparable contribution on the part of the European governments. Unfortunately some of our

spokesmen in the AID have gotten into the habit of just throwing these figures out as if they compare with U.S. aid efforts.

Senator DOUGLAS. You mean that on the soft loans, as I understand it, there is no interest for 10 years, and then one-half of 1 percent a year for the next 40 years?

Mr. DANIELIAN. The present Foreign Assistance Act has been amended to read three-quarters of 1 percent for the first 10 years and 2 percent thereafter.

It does not apply to the International Development Association, they still make no-interest loans for 40 years, and also the Social Progress Trust Fund of the Inter-American Bank, they make no-interest loans.

But, generally we make these advances and do not get anything in return, whereas the Europeans make hard loans and they get their interest and principal repaid.

Now, this is one of the ways in which I believe they increase their balance-of-payments surpluses.

Senator DOUGLAS. I hope there are correspondents for foreign papers in the room and that they report this testimony in full.

Mr. DANIELIAN. There is a second point I would like to make.

The comparisons we make do not include Public Law 480 contributions furnished us; statistics by AID to the U.S. Congress state that our contribution is 0.75 percent of the gross national product.

But that does not include the Public Law 480 as a statistic. If you include that, our contribution is closer to 1 percent or above.

So that they say then that France makes a greater contribution than we do. But if you really look at the detail you will find that France has taken over its burden of the previous colonial regimes in the African countries, so they are continuing an economic and political relationship with their African colonies. They are not lending any money to South America or to India except in small amounts in comparison with our efforts so that, in effect, these comparisons between European contributions and the American contributions are not really revealing.

Senator DOUGLAS. Mr. Danielian, I hope that you will show the same skill which you exhibited in your maiden article for the Atlantic Monthly in pointing out these facts.

Mr. DANIELIAN. I also would like to comment, Mr. Senator, on your first statement with regard to the budgetary burden of our allies in Europe in the field of defense.

There is the argument in Europe that we are richer and therefore we can afford a greater per capita burden for defense.

They also, you must admit, bask under the defensive shield of our atomic power and, therefore, they do not feel that a greater effort on their part is necessary under these circumstances.

Naturally, this has its consequences because with smaller tax burdens their economy is able to compete with ours both in Europe and in third markets. So that they have the advantage of our atomic shield without making adequate contribution on their part, to defend Europe as well as other parts of the world.

If I may go into a little further detail, the facts are that we are still about $900 million short in our defense expenditures in Europe. The amount is closer to a billion and a half but Germany is buying military equipment in the United States to the tune of about over $600 billion

so that the net outpouring for U.S. military presence is still $900 million short in Europe.

Well, it is a billion and a half or more short in the Far East and, of course, as you know, no one is really lending us much, if any, help, in the Vietnam situation, so that until there is collective assumption of responsibility for the defense of the free world against Chinese expansion as well as Soviet expansion in Europe, I don't believe we are going to be able to solve this balance-of-payments problem. This applies to economic aid also; this balance-of-payments problem cannot be solved by raising interest rates or by devaluing the dollar because the amounts of money involved, because the amount of wealth needed to maintain this effort will still be the same, and all we will do is just change the dollar figures on it.

Senator DOUGLAS. I don't want to prolong this and I have already taken more time than I should. Yet, when I have advanced this argument with English friends their reply has been, "It is true we are protected by the shield of American atomic power but for a century you were protected by British seapower. We bore the burden of support of a heavy navy which kept off the imperialistic designs of other countries upon the American continents. Therefore this is only turn about for the protection which we gave you for a century which, though you were legally unconscious of it, was nevertheless real."

Mr. DANIELIAN. Well, this does not eliminate, any historical reference does not eliminate, the practical problem of our present balance-of-payments situation and it seems to me in this area there are many things our allies can do in Europe.

For instance, they can accept more agricultural products from us, they can accept more automobiles from us, they can accept more coal, but they are not willing to do all these things that could solve this problem in terms of rational and economically acceptable means.

If they are not willing to allow us to earn a net export surplus as a conscious policy for us to be able to maintain this defensive position around the world, then the next choice on their part would be to share with us these burdens, and I am not sure that these choices have been adequately presented to our European allies.

Senator DOUGLAS. I am often a critic of our State Department. I think they have tried, however, to present these necessities to the governments, but the point is we have never tried to present them to the people of Europe.

Mr. DANIELIAN. Sunday the Foreign Minister of France on "Meet the Press" stated that he was never requested to make a contribution to the defense of Indochina—in terms of money—and of course money wouldn't help. I can hardly believe that this can be a fact. I was under the impression that Mr. Ball and Mr. Rusk at the last meeting of NATO ministers had asked them pointblank to participate in the defense of the Far East. But there is an escapism in Europe on this subject.

Senator DOUGLAS. Thank you, Mr. Chairman, I am sorry for taking so much time.

The CHAIRMAN. Thank you very much.

The next witness is Mr. John W. Hanes, Jr.

Mr. Hanes, I assume you are the son of my very dear friend John W. Hanes, are you not?

Mr. HANES. Yes, I am.

The CHAIRMAN. He was a great man and a great leader of the country.

You may proceed, sir.

STATEMENT OF JOHN W. HANES, JR., PARTNER, WERTHEIM & CO., NEW YORK, N.Y.

Mr. HANES. Thank you, sir.

My name is John W. Hanes, Jr., of Great Falls, Va.; I am a partner of Wertheim & Co., investment bankers of New York. To identify myself further, I served in the Department of State during President Eisenhower's administration, first as special assistant to Secretary Dulles, and most recently as Assistant Secretary of State.

Our firm has, among other activities, advised European financial institutions on American investments for some 40 years. We have also maintained an active interest in leading foreign securities and have handled transactions in such securities for our own and our clients' accounts. Transactions in foreign securities have not contributed significantly to the profits of our firm and are essentially a service function.

I believe that these facts permit me to speak objectively about the interest equalization tax.

First of all, I should like to express our belief that the proposed bill is basically unsound in approach and philosophy, and is inconsistent with our tradition of a free capital marketplace; that it seeks to control effects rather than correct the causes of our disturbing balance of payments situation; that it will have only a limited effectiveness with regard to balance of payments in the short term; and that it may have gravely adverse results both to our balance of payments and to our entire economy in the long term. In these opinions, we find ourselves in agreement with many other witnesses who have appeared before the Congress; and especially do we concur with the scholarly analysis presented to the House committee last year by the Honorable Andrew N. Overby, former Assistant Secretary of the Treasury. The force of his arguments has not diminished with the passage of 10 months; indeed, many of them have been supported by events. Since they are available to the committee, I shall not intrude on your time by repeating them.

The proposed tax is not a proper tax; it is not a revenue raising measure, but a utilization of the taxing power to achieve other objectives. As such, I believe it to be unsound tax policy.

It is a control on the freedom of international capital movements. As such, it is a violation of our repeated pledges and of our traditions. It is our recommendation, therefore, that the bill not be enacted.

This is not a head-in-the-sand statement. No one, I think, would seriously argue that the situation which had developed by early 1963, almost entirely involving new debt issues, was not in need of some corrective action.

It is also plain that the present bill, without being passed, has effectively shut off foreign security borrowings in our markets, and has largely eliminated American buying of foreign securities. I believe that much of this result has been due to the uncertainty and the threat of unmeasurable penalties inherent in a still pending but retroactive bill, which remains subject to major revision or possible rejection by

the Congress. Such control by fear is an unhealthy and extralegal situation, totally inconsistent with the American way of doing business, either legislatively or in our marketplace.

There is no guarantee—indeed, there is not even the likelihood—that actual passage of the bill would continue the present shutoff of borrowings. Until now, security issues, even those which would presumably be exempted from penalty, have been avoided because the exemptions are not yet law. Also, once the extra cost of borrowing in the American market is finally established as a known quantity and with known requirements, there are, I am certain, many foreign borrowers who will elect to pay the penalty in order to gain access to our capital market. So the future effectiveness of this tax cannot be predicted from the results of the past 11½ months of limbo.

Even those apparent results are questionable. Security transactions have certainly ceased; but there has been an enormous counteracting rise in foreign borrowings from U.S. commercial banks. Such borrowings are just as much net outflows as are security borrowings, and those figures must be included if we are to make a valid assessment of what has happened since July 1963.

It is important to recognize, however, that the proposed tax is not the only alternative to inaction.

The investment banking community has made clear its recognition that a problem of heavy net outflows of funds did arise, and could recur; and that it must be viewed in the context of our perilous balance-of-payments position, even though it may be far from a fundamental cause of that position.

The creation of a Capital Issues Committee, for example, preferably on as informal a basis as possible, with close governmental cooperation but without governmental control, would be one solution consistent with our tradition of economic freedom coupled with economic responsibility. Such a group could deal flexibly both with changing circumstances and with the widely varying merits of particular situations. The complexity of the proposed law and the number of modifications it has already had from the very day it was proposed (including the most recent group of amendments proposed by the Treasury) testify compellingly to the need for flexibility—and the near impossibility of achieving it by statute.

I believe that such an approach, based on willing cooperation and informed discretion, rather than punitive taxation, would achieve far better our objective of defending the dollar without endangering the international image of our free and strong economic society.

There is another quite different possible approach, which also could accomplish the desired ends while avoiding many of the problems of the proposed tax.

This would be to tax the income from any new debt or equity purchased from a foreign person or issuer, rather than taxing the capital transaction itself. Such a tax would apply only to new commitments undertaken after the effective date of the tax; but it could apply to all such investments and debts, including bank loans.

If the average differential of domestic and foreign interest rates is considered now to be 1 percent, then the tax on income should be approximately 17 percent in order to reduce a 6-percent yield to 5 percent. The precise figures could easily be worked out.

Such a tax would not seriously affect equity transactions, since most equities are not bought primarily for their income. It would accomplish directly the same objectives for debt obligations as the proposed tax, if the true purpose of the proposed tax is to equalize interest rates, and it would not require getting into the difficult question of how long an obligation is to be held.

It would be far less disruptive, in that it does not affect the capital markets except by varying interest rates. It is a much simpler tax to remove without major problem when the time comes to do so; and its form is not a departure from our traditions, as is the interest-equalization tax on capital transactions.

If, however, it is the decision of the Congress that some restrictive controls must be imposed on capital transactions themselves via the tax route, it is then our recommendation that such action be confined to new securities' issues as opposed to already outstanding issues; and preferably only to new debt issues, excluding, also, new offerings of equity securities.

I will not dwell on these technical suggestions, however, but I would like to discuss briefly certain other aspects of the bill which I believe go far beyond the technical in their significance.

The inclusion of presently outstanding foreign equities illustrates vividly the contradictions inherent in this tax.

In his earlier testimony before the Congress, Secretary Dillon seemed aware of the weakness of his position in this regard. Having dealt with the matter of outstanding bonds, he went on "* * * regarding equities, the situation is somewhat different. It is more of a question of what is equitable * * *."

Let us then examine what is equitable.

How big is the proposed burden? Secretary Dillon has argued that by dividing the 15 percent over the lifetime of the security, the cost can be calculated at 1 percent per year. Now this argument may be valid for the foreign borrower, but it is completely irrelevant to securities where no foreign borrower is involved.

It is an essential element in equity investments that they are marketable. Therefore, the investor wants to be in a position to sell his holding at any time. To be rational, he must regard the investment tax as an immediate loss of 15 percent. As far as outstanding securities are concerned, the cost is 15 percent, and a 15-percent tax is prohibitive.

A 15-percent tax effectively removes American investors as potential buyers from the world's equity markets. It does not remove them, however, as potential sellers. On the contrary, they have good reason to reconsider their attitude toward holding foreign securities. When they made their commitment, trading in foreign securities was unrestricted. They could switch from one holding to another; and, if they found a good investment, they could expect other investors to follow them, thereby assuring them of a reasonable chance of capital appreciation.

The proposed 15 percent tax would reverse this situation. American investors cannot expect to buy without incurring punitive taxes, and they have good reason to expect the foreign shares they own to be subject to continued selling pressure from other American holdings as they are progressively liquidated. The pressure will fall on the relatively few securities which have been favorites among American

investors; and the closer the association of any given country or company with the American market in the past, the greater the danger to which its shares are exposed as a result of the proposed tax.

Such selling pressures have already developed to a marked degree since the tax was proposed. American holdings of five leading English equities, for example, have declined 43 percent during the past year; of two top German securities, the decline was 18 percent; and the American holdings of four similar Japanese equities have dropped 32 percent. Such distress sales have obviously had an adverse effect on the price of these stocks. It is true that our balance of payments has benefited to a small degree from these dispositions by American holders—but at what cost?

It is clear, of course, that continued foreign investments by Americans are highly valuable from the long-term balance-of-payments point of view. Indeed, the optimism generally expressed in connection with the long-term outlook is largely based on anticipation that our investments will bring increasing returns. The proposed bill, however, will drastically curtail the future golden egg production of this particular goose.

Furthermore, the foreign countries and companies that will be affected are not only our most faithful friends, but also our most reliable ones. They have fostered and welcomed American investments, and have created and maintained conditions of prosperity and stability which private capital has found attractive. We have disbursed large sums of money abroad since the end of the war; such private investments belong to that relatively small proportion of it on which we can expect a decent return.

The damage which the proposed bill will inflict in various countries is in direct relation to the closeness of the ties between us. On our continent, the Canadian economy would have been so severely affected that the proposed bill had to be modified within hours. In Asia, the Japanese market suffered perhaps its worst setback in history. In Europe, the impact of the proposed tax was noticeably greater in Germany, which welcomed American investment in the past, than in France which is discouraging it.

It is not difficult to see how the proposed tax brings grist to the mill of those who advocate a reduced dependence on the United States. We are providing them with a precedent for future retaliation. We restrict portfolio investment; they may impose controls on direct investment, or perhaps, under certain circumstances, on the repatriation of capital. We are seriously impairing our right to protest.

The connection between these repercussions and the near-term balance of payments is indirect, but it is nonetheless very real. It is nothing less than the international confidence in our currency and our economy, which, in turn, is the most important single factor in the current balance of payments. We stand at the mercy of that confidence, for it is all that prevents the vast short-term dollar obligations held by foreigners from being demanded in gold.

Secretary Dillon has estimated the possible saving of the proposed tax at about $500 million per year. I believe that when the exemptions for Canada, underdeveloped countries, international institutions, short-term loans, commercial bank loans and all the rest have been deducted, this figure is very optimistic. But this much is true:

if we save even $500 million at the cost of international confidence in our policies, we shall pay a price many times the value of what we get.

It is one of our greatest national assets that, in a world increasingly attracted by the superficial appeals of socialism and governmental control and regulation of all economic forces, we have both maintained a free marketplace and demonstrated its value to the well-being—and the political health—of our people. We have done this so successfully that much of the rest of the world has been attracted to participate in it; perhaps this fact has created temporary problems for us, but it unquestionably has made a massive contribution to our past growth. It can do so for our future prosperity—if we don't destroy it.

In a real sense, our Government was a party to the commitments which it has encouraged and allowed investors to make in foreign securities. These commitments were made in a free market environment, with the implicit understanding—based on our entire history and fostered by the repeated pledges of our leaders—that this market environment would remain free.

If we now feel so threatened that we must restrict this environment—even to a limited extent or for a limited period of time—we cannot be surprised if the psychological effect far outstrips the perhaps modest bounds of the immediate action itself. For we are tampering with a precious asset which is intangible as well as real, and which rests on a long and arduously created structure of confidence. Many, here and abroad, will not believe that this action will be temporary, or that it will be the last, or the most drastic. Even if it later proves so, it will be a painful and long task to erase its memory when the immediate crisis is past.

We should pause, therefore, and give thought to whether we have truly explored all alternatives; and to whether the danger is truly so threatening, and the results of this drastic change in our traditional policy so unquestionable as to justify putting at risk one of the foundations of our economic structure.

We doubt that these questions have yet been answered affirmatively.

(The memo referred to follows:)

MEMORANDUM CONCERNING THE INTEREST EQUALIZATION TAX

The interest equalization tax is designed to curb the outflow of portfolio capital, which showed an accelerating trend in the first half of 1963. We believe that such a tax, if it is enacted at all, should be confined to new issues of debt securities. Outstanding securities, both debt and equity, should be excluded, as should new equity issues.

For the sake of clarity, we shall classify the securities subject to the proposed tax as follows:

1. New issues of debt securities.
2. Outstanding debt securities.
3. New issues of equities.
4. Outstanding equities.

The balance-of-payments problem which this bill is designed to deal with concerns only the first category; namely, new issues of debt securities. This fact is admitted by the administration.

In Secretary Dillon's own words when he testified last August, "clearly, the major problem at the moment, in terms of sheer dollar volume, relates to new debt issues. These accounted for more than four-fifth's of the outflow from all portfolio transactions in foreign securities over the first half of this year, and for the bulk of the increase over the past 12 months."

The following figures will put the problem in perspective:

TABLE I.—*Analysis of foreign security transactions*

[Minus represents net outflow; in millions of dollars]

	1st half, 1963	1962	1961	1960
New issues (less redemptions):				
(1) Debt	−899	−832	−364	−459
(2) Equity	−7	−74	−36	−14
Outstanding securities:				
(3) Debt	−124	−29	−27	−102
(4) Equity	−3	−26	−326	−75
Total	−1,033	−961	−753	−650
New debt issues as a percent of total	87	87	48	71

Source: Hearings before Committee on Ways and Means on H.R. 8000, pp. 85, 86.

It can be seen that in the first half of 1963 the outflow of long-term portfolio capital was running at more than double the already inflated rate of 1962, and the increase was due almost entirely to new issues of debt securities.

As a matter of fact, the importance of outstanding securities from the point of view of H.R. 8000 is even less than the above table indicates. The proposed tax does not apply to outstanding securities of undeveloped countries and international institutions. If these securities are excluded, transactions in outstanding securities resulted in a net inflow in 1962 and only a very modest outflow in the first half of 1963. The following table, which combines outstanding debt and equity transactions, clearly shows this fact.

TABLE II.—*Transactions in outstanding securities*

[Minus represents net outflow; in millions of dollars]

	1st half 1963 [1]	1962	1961	1960
Total outstanding securities	−112	−55	−353	−177
Europe, Canada, and Japan	−39	+55	−317	−123
Others including international institutions	−73	−110	−36	−54

[1] NOTE.—The 1963 1st half total does not correspond precisely with table I, presumably because the sources used differing definitions of "outstanding securities." The difference is not significant.

Source: Survey of Current Business, September 1963, p. 14.

The balance-of-payments problem in this area which arose in 1962 and the first half of 1963 is confined, therefore, to a sharp increase in new issues of debt securities. The influence of the other three categories has been negligible. The only reason advanced by the administration for including them in the proposed tax is that their importance may possibly increase in the future if a tax is imposed on new issues of debt securities. We shall deal with each category separately.

Outstanding debt securities.—Secretary Dillon has argued before the House Ways and Means Committee that "the interest of American investors in outstanding foreign debt issues could be expected to rise very substantially if such issues remained freely available without tax, while the volume of new issues reaching our market contracted." We believe this statement is difficult to sustain.

The volume of foreign dollar bonds currently outstanding is limited and can be increased only by means of new issues. It is true that substantial amounts of foreign dollar bonds are currently held by foreign investors; but there is no good reason to expect that these foreign owners would become more anxious to sell such holdings than they have been in the past, unless American investors were willing to pay them a substantial premium to do so. But for an American investor to do so would diminish, and probably eliminate, the interest advantage which would have attracted him to a foreign debt issue in the first place.

It has been argued that a tax on new debt issues could be frustrated by issuing them abroad and then selling them relatively soon in the United States as outstanding issues. Such a possibility can easily be removed by imposing a limitation on the date of issue of bonds exempt from the tax.

It has also been suggested that there might develop a procedure whereby a foreign issuer would buy up outstanding dollar bonds and sell them to Americans, replacing them to the foreign holder with a new issue. In other words, when a new issue came along, the seller of the new issue abroad would merely go to his clients and say: "Here, take this new issue, and I will take in payment your old issue, and then I will go sell that in the United States."

Now it should be recognized that trading in outstanding bonds moves through quite different channels than the placing of new issues. The bulk of new issues in the first half of 1963 consisted of private placements; these require a higher interest rate than marketable securities of a comparable grade. Therefore, it would be impracticable to use the private placement technique for already outstanding bonds. Moreover seasoned bonds command a higher price than new issues and are rarely available in large blocks. The difference in interest levels would have to be very substantial, probably more than 1 percentage point, to make the transaction suggested above feasible.

New issues of equities.—With regard to new issues of equities, Secretary Dillon stated before the House Ways and Means Committee that "the issuance of equities is an alternative to debt financing in raising capital, and the choice is directly influenced by relative cost. Similarly, for many investors, bonds and stocks represent alternative uses of funds. Both debt and equity capital are relatively cheap in the United States today, and in these circumstances it would clearly be inconsistent to tax foreign access to one market and not to the other."

We believe that the following facts diminish the force of this argument:

(i) A major part of foreign debt issues are floated by governments and other public or quasi-public entities which have no common stock available to the public.

(ii) As far as corporate bonds are concerned, more than half of them are placed privately, and many of the financial institutions involved are prevented by their statutes from taking common stocks instead of debt securities.

(iii) The public sale of equities is governed by the Securities and Exchange Commission and foreign corporations often have difficulties in meeting SEC reporting and other requirements. This has been a major inhibiting factor to the underwriting of foreign equities in the past and can be expected to remain so in the future.

The Investment Dealers' Digest published the following statistics concerning new issues of foreign securities sold to the public by U.S. underwriters, as distinct from private placements.

TABLE III.—*Underwriting by type of issues*

[In millions of dollars]

	2d half 1963	1st half 1963	1962	1961	1960
Foreign government bonds	60.0	172.5	217.5	148.0	214.3
Foreign corporate bonds and preferred stocks	24.9	25.3	120.5	29.5	45.0
Common stocks	36.9	35.4	20.6	9.5	----------

Even if corporate bond issues were replaced by equity issues whenever possible, the amounts would remain insignificant. In the first half of 1963, for instance, the increase in equity issues would have amounted to only $10 million, because the remaining $15 million of corporate bonds was represented by an issue of the Copenhagen Telephone Co. which has no private stockholders.

Furthermore, if it is deemed desirable to discourage or restrict new issues of equities, other less drastic means to accomplish this should be available, such as by utilizing existing SEC procedures.

Outstanding equities.—None of the foregoing arguments apply to trading in outstanding foreign equities. Even Secretary Dillon was only able to say before the House Ways and Means Committee that: "American investment advisers and investing institutions, including pension funds, with increasing frequency seem

to believe that diversification could be improved by investing a portion of ther assets in foreign equities. When one considers the billions of dollars currently invested in stocks by pension funds alone, it is easy to realize that an attempt to place only 5 percent of these assets in foreign securities—as some have recently begun to do—could lead to an outflow of many hundreds of millions of dollars per year, far outpacing our efforts to induce more purchases of American securities by foreigners. Regardless of the merits of such diversification in the long run, there is no question but that a cascading of such purchases in present circumstances would gravely strain our overall balance-of-payments position."

There is no factual evidence to indicate that any such "cascading" was in the process of developing. On the contrary, transactions in outstanding securities of the countries which would be subject to the proposed tax resulted in a net inflow of dollars in 1962 and a smaller than average outflow in the first half of 1963. Incidentally, it is misleading to utilize figures concerning gross purchases because they include only one side of an investment switch or arbitrage operation, and there may be a corresponding sale. The only thing that matters for the balance of payments is net purchases.

There is no reason to believe that the imposition of a tax on new foreign debt issues would lead to a "cascading" increase in purchases of outstanding foreign equities. Such purchases are governed by the attractiveness of foreign business enterprises and markets relative to our own. Insofar as the proposed tax would have any effect at all, it would be to make foreign equities less attractive by making it more difficult for foreign companies to meet their financing requirements by debt issues.

There is a suggestion in the administration's argument that the imposition of a tax on new issues would make American investors more anxious to send their funds abroad by purchasing outstanding foreign equities. Although this argument is not stated explicitly, we should like to deal with it here so as to avoid any possible confusion.

The proposed tax would in no way hinder the transfer of capital abroad (*a*) for safekeeping in a foreign currency; (*b*) for lending to foreign borrowers provided the loan has a maturity of less than 3 years or (*c*) for the purchase of any property other than securities. There is no logical connection between the transfer of funds abroad and the buying of foreign equities. On the contrary, the purchase of equities requires a forward-looking optimistic attitude which is the exact opposite of the attitude motivating flight capital.

To sum up: While there is some relationship between new debt issues on the one hand and outstanding debt issues or new equity issues on the other: the relationship between new debt issues and outstanding equities is so tenuous and indirect that it can be safely regarded as nonexistent.

As regards outstanding debt issues and new issues of equities, it has been shown that there are strong technical reasons why it is unlikely that private investment abroad should shift to these categories if a tax is imposed on new issues of debt securities. The extension of the tax to the three other categories would make no significant contribution to the solution of our balance-of-payments problem. On the contrary, it may have farflung adverse repercussions by interfering with the free market mechanism over a much broader field than is necessary.

The CHAIRMAN. Thank you very much, Mr. Hanes, for a very excellent statement.

The next witness is Mr. Adolphe J. Warner, from Model, Roland & Co.

STATEMENT OF ADOLPHE J. WARNER, PARTNER, MODEL, ROLAND & CO., NEW YORK, N.Y.

Mr. WARNER. Mr. Chairman, distinguished members of the committee, my name is Adolphe J. Warner. I am a general partner of Model, Roland & Co., New York, members of the New York and American Stock Exchanges.

We do a general securities business as brokers, dealers, and underwriters. For many years we have specialized in placing American securities with investors abroad and, conversely, foreign securities

with American clients, mainly financial institutions. Through this activity, and through our offices in London and Paris, we maintain close contacts with all the principal financial markets abroad. Thus, our business permits us to observe the daily flow of portfolio investment between this country and many others at close quarters. It is our conviction that the significant changes in the composition and size of our balance-of-payments deficit, particularly within the area of private portfolio investment, during the last year have been such as to render the proposal now before you both unnecessary and inadvisable. We take this position, not because of any feelings of complacency about the need to strengthen our balance of payments, but because of our doubts that the proposed interest equalization tax represents the best method of achieving this.

On July 18 of last year, President Kennedy sent to the Congress a number of recommendations for dealing with our balance-of-payments deficit. Two of these recommendations specifically referred to portfolio investment. One suggested a direct action program to promote overseas sales of U.S. securities which, in President Kennedy's words—and I am quoting verbatim—"should be one of our best selling exports."

The other proposed the interest equalization tax in order to reduce U.S. purchases of foreign securities. Apart from the apparent inconsistency between these two suggestions to which I shall revert later, let me begin by highlighting the changes that have taken place in our balance-of-payments position since the proposal before you was first introduced.

There has been a dramatic improvement in the U.S. balance of payments in the last 9 months. Most of this is due to the greater strength of our current payments—particularly our exports of goods and services and our earnings on foreign investments. There has also been a reduction in new issues of foreign dollar bonds. We still have a balance-of-payments problem, but it is much less serious than it was a year ago and, I might add, also not as bad as our overly conservative presentation of the accounts makes it appear.

In any case, the introduction of this tax proposal has had an undeniable effect in reducing the amount of foreign borrowing here—be it through publicly issued dollar bonds or through private placement of dollar debt. However, the proposed tax lays equally against American purchases of stocks which, in the great majority of cases, are not new issues, but represent acquisitions of existing securities from foreigners. This form of foreign investment has not contributed to the deficit since late in 1962, when sales of existing American holdings of foreign stocks began to exceed new purchases. Last year, such net sales contributed $51 million to our receipts, and during the first quarter of this year, this contribution rose to $89 million, or an annual rate of over $350 million.

The divergence between this movement and that of foreign dollar bonds points to a number of significant differences between these two types of foreign portfolio investment. To begin with, foreign stocks are seldom bought for considerations of yield, because yield levels in most foreign markets are, at best, no higher than those obtained from American stocks. Thus, the concept of interest equalization does not apply to them. Moreover, the aggregate amount of such purchases

has consistently been much lower than the total amount of new dollar bonds with their special appeal to many of our large financial institutions.

Lastly, there is a certain relationship between American purchases of foreign stocks and foreigners buying American stocks. For many years, British investment trusts have been buyers of American utility stocks, and IBM is one of the most popular securities with French individual investors. Now that American holders have sold an average of between $30 and $35 million of foreign stocks on the securities markets of Western Europe and Japan month after month, the funds utilized abroad to absorb these concentrated sales are no longer available for foreign purchases of American securities. This tends to neutralize the balance-of-payments benefit of our own selling. Back in 1961, when Americans had bought a record total of $370 million worth of foreign stocks, foreigners' purchases of U.S. equities covered seven-eighths of that total, $328 million. Even in 1962, the year of the sharp fall in stock prices and of the Cuba crisis, foreigners were net buyers of $111 million of our stocks, and last year, this balance showed a healthy rise to nearly $200 million. Early this year, however, the continuing pressure of U.S. sales of foreign securities turned this into a deficit figure for the first time since 1958. In February of this year foreigners sold $26 million worth more than they bought, and in March such sales rose to $51 million; moreover, the sold another $11 million of bonds—mainly U.S. Government bonds—during that month.

There is hardly cause for congratulating ourselves on this dubious achievement which, quite apart from having offset some of the gains from our own sales of existing foreign securities, have hampered the recommended effort to increase foreign purchases of American securities to which I referred earlier. This effort had been spearheaded by a task force directed by Mr. Henry Fowler, then Under Secretary of the Treasury. It is difficult to reconcile the recommendation of that task force that the U.S. Government should—and I quote literally—"seek to increase the freedom of capital movement to induce foreigners to buy our securities," with the almost simultaneous proposal to reduce this same freedom when American purchases of foreign securities are concerned. This is what might be called the Hawley-Smoot approach to foreign investment; and its effect may well backfire on us as disastrously as did these tariff proposals some 30 years ago.

The proposal to tax foreign dollar bond issues and existing foreign stocks alike contains a further risk which we believe to be of sufficient importance to warrant a distinction between the two categories. This risk has to do with the confidence which foreign holders of dollars place in the stability of our currency.

What the interest equalization tax proposes amounts to a demonstration that the U.S. dollar held by a resident is no longer able to purchase in the different capital markets abroad what any other convertible currency would purchase. To illustrate, where Swiss francs, German marks, and Dutch guilders will buy a share of Royal Dutch Petroleum, for instance, at the equivalent of $45, figured at the official exchange rates, an American would have to pay $52 a share in the same markets. Price disparities of this kind, which would show up widely through quotations published in the daily press, could cause foreigners to liquidate some of their assets in this country. As transactions in

equity securities have had no part in our balance-of-payments deficit for very nearly 2 years now, it would seem to be a matter of commonsense to exempt this type of security from the proposed tax. It is not in the interest of the United States to hamper international investment in common stocks, as it is the stocks of our own companies which are, in fact, most attractive to international investors.

Thank you for your kind attention.

The CHAIRMAN. Thank you very much.

Senator DOUGLAS. If the Senator from Utah has questions I will defer. Following any questions he may have, there is one question I should like to ask.

Senator BENNETT. I should just like to thank you, Mr. Warner, for adding another in this very interesting and convincing structure of arguments against the bill.

That is all I have to say.

Mr. WARNER. Thank you.

Senator DOUGLAS. Mr. Warner, I would like to ask you about a statement which you make.

You say—

> foreign stocks are seldom bought for considerations of yield, because yield levels in most foreign markets are, at best, no higher than those obtained from American stocks.

Did you hear the testimony of the Secretary of the Treasury yesterday that the price of American stocks on the New York Stock Exchange was approximately 19 times the yield?

Senator BENNETT. Nineteen times earnings, not yield.

Senator DOUGLAS. Yes.

Mr. WARNER. This is the so-called price-earnings ratio.

Senator DOUGLAS. Yes, and in Germany the ratio was approximately 13 or 14 times the yield.

Mr. WARNER. I believe that statement to be correct, sir.

Senator DOUGLAS. May I just follow up the consequences of that. This would mean that an investment of $100,000 in American stocks would have a yield of approximately $5,250. Well, the yield would be the $100,000 divided by the 19, would it not?

Senator BENNETT. You are confusing earnings and yield.

Senator DOUGLAS. All right. Supposing we say earnings.

Mr. WARNER. In terms of earnings, Senator, I think your point is well taken.

Senator DOUGLAS. Let's follow the arithmetic through. The earnings would be about $5,250, would they not?

Mr. WARNER. Entirely correct.

Senator DOUGLAS. Now in Germany the earnings would be approximately $7,000, isn't that correct?

Mr. WARNER. Entirely correct, sir.

Senator DOUGLAS. So the earnings on a given amount of investment in Germany would be greater than the earnings in the United States, isn't that true?

Mr. WARNER. Precisely.

Senator DOUGLAS. Is it your contention that these earnings are not distributed in the United States to the same degree that they are distributed in Germany?

Mr. WARNER. Oh, entirely so, only it is the other way. The rate of distribution, the so-called payout ratio, is much lower abroad than it is here.

Senator DOUGLAS. Well, then doesn't that weaken your case still more?

Mr. WARNER. I don't think so if we talk about return, because return is a function of the payout, and not of retained corporate earnings.

Senator DOUGLAS. Are you saying that retained earnings abroad are greater than here?

Mr. WARNER. I do indeed, sir.

Senator DOUGLAS. Greater or less?

Mr. WARNER. They are much greater.

Senator DOUGLAS. In what detail?

Mr. WARNER. In relation to the amount paid out to the stockholder. Let me, if I may, for a moment clarify this.

Senator DOUGLAS. Yes, surely.

Mr. WARNER. To take your own figures, Senator Douglas, out of the $5,200 earned by the American corporation, in your $100,000 original investment now, on this $5,200 the average American holder would receive $2,500.

Senator DOUGLAS. How much?

Mr. WARNER. $2,500.

Senator DOUGLAS. Out of how much?

Mr. WARNER. $5,200.

Senator DOUGLAS. That used to be the ratio, but it was then about 50–50, but hasn't this changed in recent years so that the ratio is closer to 60–40 than 50–50?

Mr. WARNER. If you talk about manufacturing industry, I think my ratio is still about right.

If you include utilities and other regulated industries which by virtue of their guaranteed return on statutory capital investment you will get a much higher payout—as these companies pay out 80 percent, you would indeed get your 60-percent figure, that is correct.

Senator DOUGLAS. I simply go on the basis of the figures published monthly in the economic indicators. Those show that in the last 5 or 6 years there has been a decided change from the old 50–50 ratio, to a ratio in favor of a larger distribution.

Mr. WARNER. Yes. That is entirely correct. As I say, including all industry you will get to a good healthy 60 percent.

Now, this in Germany——

Senator DOUGLAS. I would say now it would be nearer $3,000 rather than $2,500.

Mr. WARNER. Precisely. In Germany it would be half that. In France it would be less than half that. The payout to the stockholder, in other words, given the limitation of foreign capital markets, Senator, must remain much more modest in relation to earnings than it is here. This is a function of the capability and size of the capital markets.

If you can go out and raise external funds at 4 or 5 percent, there isn't the same need to retain earnings, that you have in Europe, where borrowing possibilities are much more limited.

Senator DOUGLAS. Even if it were one-half of a 7-percent yield, that would be a $3\frac{1}{2}$-percent distribution, that distribution is greater than a 60-percent distribution of a 5-percent yield.

Mr. WARNER. Exactly; but I didn't use a figure of one-half. I used a figure of 30 percent. I do believe that for countries like Germany, France, and Italy, 30 to 35 percent payout represents a good working range.

Senator DOUGLAS. It is a very important point.

Mr. WARNER. It is extremely important.

Senator DOUGLAS. I don't want to overburden you with work but could you submit figures on this point?

Mr. WARNER. I would be delighted to submit a memorandum on this point. The difference in these figures, Senator, is that these countries do not require their corporations to declare either to the stockholder or to the public at large their true earnings, so that certain estimates have to be made as to what these companies really earned.

These countries do not have Securities and Exchange Commissions, and their stock exchange authorities do not require full disclosure of earnings so that you will find, if you look at a typical French or Italian corporate annual report, an apparent payout of 99 percent; in other words, if the company earns $100,000 it will then turn around and declare a dividend of $99,000 and carry over $1,000 to the next year.

Senator DOUGLAS. This presents a very interesting paradox. If European corporations do not distribute as large a proportion of their earnings to stockholders as we would expect there would be a greater appreciation of the principal.

Mr. WARNER. This, I think, would be true——

Senator DOUGLAS. And therefore you would expect a greater appreciation in stock prices.

Mr. WARNER. This, sir, would be true except for my earlier point. You cannot expect the stock market to evaluate nondisclosed earnings with the same methods you use as to disclosed, that is, reported earnings.

If I know American Telephone & Telegraph earnings are $3 a share and the company pays out $2, I can evaluate both of these figures, can evaluate the $2 dividend in the light of our stock-bond yield structure and I can evaluate the $3 figure in the general comparison of price-earnings ratios which you referred to, the $19\frac{1}{2}$ times figure.

In Europe much of this is guesswork. When I say Europe, Senator, let me clarify, I am talking now about continental Europe. It does not apply to Great Britain.

In Great Britain, at least since 1948, British corporations report more along the lines of what is required by American corporations.

On the European Continent however, corporate law does not yet require a company to disclose to the stockholders its true earnings in the sense of the earnings on which they are assessed for tax purposes, so that we cannot make the comparison, and it would be my contention and I want to—I don't want to be overly dogmatic about this, because there could be some area of disagreement here or partial disagreement.

Here, as a securities analyst, I don't feel I can apportion the same statistical weight to earnings which I have to estimate than to earnings which are disclosed by the earnings in fact.

Senator DOUGLAS. How can you as an analyst of international securities ferret out the information concerning the large concealed profits, which are not distributed to stockholders but invested in corporations? What is the secret? How do you operate as a skilled detective in these matters?

Mr. WARNER. I think that is a very apt comparison, Senator. In fact, I think it is rather flattering, because detective work is precisely what we are doing but of a very precise kind.

There are no great secrets, however, at least in certain industries. Take the electrical industry; this is a very international business. GE bids for contracts in Europe and in Brown Boveri or Siemens, for instance, in South America and in the Middle East. Cost factors, by and large, cannot remain secret for very long in an industry such as this.

The chemical industry is different. In the chemical industry, you could make a special purchase contract and get a price that no one knows about because of quantity purchases. When you deal, as you do in electrical equipment manufacturing, with a 40-percent labor component and, steel, and copper, you can't kid anybody very much about your costs.

Now the question remains, What are your margins? Well, here the detective goes to work. There are a lot of things we know about margins which are not disclosed by the company but which nonetheless, by putting two and two together, you can figure out quite well.

We know, for instance, that when a European exporter of electrical equipment, say, generating equipment, to Latin America or to southeast Asia, has a transaction of this kind, which runs into millions of dollars, he normally gets some kind of government guarantee.

Now the government guarantee will take into account his profit margin: and if we can find out—and very often these are matters of public record—what the pattern of financing is, this gives us one clue, but there are of course many others, such as return on sales, return on invested capital, turnover of inventories or receivables, to name just a few.

These others, however, vary from country to country. In Germany, oddly enough, even though company law does not require the publication of true earnings, income taxes must be stated in the reports——

The CHAIRMAN. The chairman dislikes very much to interrupt the witness but we have two other witnesses here today.

Senator DOUGLAS. May I say, Mr. Chairman, this is not the witness' fault, as we got into a field most interesting to me.

The CHAIRMAN. I think it is very interesting and I hope you will put it in a memorandum.

Senator DOUGLAS. I hope this won't prejudice the case of the witness.

The CHAIRMAN. This won't prejudice the case of the witness but we should have some consideration for the witnesses we have not heard and they have been waiting patiently.

Thank you very much and if you wish you can put it in the record.

Mr. WARNER. Thank you, sir. You have been most kind.

The CHAIRMAN. The next witness is J. D. Winzenried of the Husky Oil Co.

Senator BENNETT. Mr. Chairman, while Mr. Winzenried is coming forward, Senator Simpson had expected to present him to the committee.

Are you from Wyoming?

Mr. WINZENRIED. Yes, sir.

Senator BENNETT. I know the Husky Oil Co. is domiciled in Wyoming but the Republicans have an important luncheon today, we are going to hear Henry Cabot Lodge report his experiences or make some kind of a report to us, his Republican colleagues and, frankly, I am getting a little bit concerned. I don't want to miss it.

Senator DOUGLAS. I didn't realize that meeting was today.

Senator BENNETT. I know the president of the Husky Oil Co. as a long-time good friend and so I would like to step forward for Senator Simpson and introduce Mr. Winzenried and his company to the committee.

The CHAIRMAN. You may proceed, sir.

Mr. WINZENRIED. Thank you very much, Senator.

Senator BENNETT. May I presume, Mr. Winzenried, to say there are three of us here. With the time limit that we now face we probably will not ask you many questions and to a certain extent if you could really highlight your testimony all of it will be in the record, and this might shorten up the process.

The CHAIRMAN. Mr. Winzenried, I would like to compliment you, too, on the work of the Tax Foundation Research staff. I have been in close touch with the Tax Foundation and you have done very fine work.

Mr. WINZENRIED. Thank you, sir.

The CHAIRMAN. Proceed, sir.

STATEMENT OF J. D. WINZENRIED, SENIOR VICE PRESIDENT, HUSKY OIL CANADA, LTD.

Mr. WINZENRIED. My statement is very short, I can summarize it even further if you like.

Senator BENNETT. I hadn't seen a copy of it. It is only three pages, I am sorry.

Mr. WINZENRIED. Senator, you mentioned the Husky Oil Co. The Husky Oil Co. is domiciled in Cody, Wyo., and I reside there. I am also senior vice president of Husky Oil Canada, Ltd., the company which I am representing here today.

We believe the interest equalization tax bill, H.R. 8000, in its present form will unjustifiably penalize the stockholders of Husky Oil Canada, Ltd. Although over two-thirds of the shares are held by U.S. persons, our company cannot meet the second requirement for exemption from the tax as a domestic company because the principal trading of Husky's shares in 1962 was on Canadian exchanges. This is an anomalous situation since not only do we have very substantial American ownership but we began business in 1938 in Cody, Wyo., and roughly one-half of our total assets, income and more than one-half of our employees are in the United States.

We feel that trading is neither an accurate nor an equitable measure of American interest in a particular company. It is not accurate because foreign trading may involve only citizens of that particular country and may have no effect whatever on the balance of payments.

Nor is it equitable because the foreign trading may be confined to a relatively small number of shares which are turned rapidly.

Our own experience in 1962 is an example. During that year trading of our shares in Canada was about 2½ times that in the United States due largely to merger rumors concerning the company. Because of the tendency of our U.S. shareholders to hold Husky shares for investment rather than to trade strictly on speculation, we feel that most of the trading in Canada involved citizens of that country and had little or no effect on the balance of payments. We do not believe it is fair to penalize our U.S. shareholders (many of whom invested in the original American company) for adhering to this investment philosophy.

We believe that the single measurement of stock ownership would be more equitable for qualifying a company as a domestic corporation. This is a relatively stable measurement which shows little variation from year to year. The volume of trading is subject to wide fluctuation depending upon general business conditions and activities of the individual company.

An alternative, although we do not believe it to be as desirable as adoption of the single measurement of stock ownership, would be to permit a company to qualify as a domestic company if it meets either of the stock ownership or principal trading tests now contained in paragraph (3) of section 4920(a) of the bill.

A third possibility to consider pertains specifically to Canadian securities. Secretary Dillon, in testimony before the House Committee on Ways and Means, pointed out that certain economic conditions make it desirable to exclude new issues of Canadian securities from the interest equalization tax. It would appear that those same conditions would also favor the exclusion of existing issues of Canadian securities, particularly since this additional exclusion would have very little if any measurable effect on our U.S. balance of payments.

The United States and Canadian economies are very closely intertwined. Each depends heavily upon the other in both buying and selling of goods and services, although the United States exports considerably more to Canada than it imports from Canada. In the long-term interest of all Americans, great care must be taken to avoid measures which could have adverse effects on relationships between the two countries.

(The material referred to follows:)

Husky Oil Canada, Ltd.: Ownership of shares by location, Dec. 31, 1962

	Number of shares	Percent of total
United States	4,120,796	67.5
Canada	1,851,639	30.5
Other foreign	150,408	2.0
Total	6,122,843	100.0

The CHAIRMAN. Thank you very much, sir.

Any questions?

Thank you, sir.

Now, the next and last witness is Mr. Charles King, of Charles King & Co.

Mr. King, if you abbreviate your statement—I say if you can abbreviate your statement we would greatly appreciate it and insert whatever you want in the record.

STATEMENT OF CHARLES KING, MEMBER, CHARLES KING & CO., NEW YORK, N.Y.

Mr. KING. Mr. Chairman and members of the Finance Committee, my name is Charles King. I am a member of the firm of Charles King & Co., a domestic partnership engaged in the securities business which for many years has had offices in New York and Canada. Our firm is a member of the American Stock Exchange and of the Toronto and Montreal Stock Exchanges. Our Canadian office acts as a principal in the international securities markets in arranging transactions among foreigners in foreign securities, and engages in a considerable amount of international arbitrage transactions. Our firm also has several floor brokers on the Canadian exchanges.

I appear in opposition to H.R. 8000 because I believe it represents a radical departure from our basic policy to maintain a free capital market. I believe it would be ineffective to accomplish the purposes claimed for it, and harmful to our position as a principal capital market for the free world and to our future balance-of-payments position. In the limited time I have for this appearance, however, I shall confine myself to the destructive effect of the bill on our long-established Canadian business.

The bill in its present form harshly discriminates against our Canadian dealer transactions effected among foreigners in foreign stocks by subjecting such transactions to the maximum 15-percent tax under the bill. While thus taxing transactions in foreign stocks, the bill permits similar transactions by American dealers in foreign bonds to be effected tax free, and also exempts distributions to foreigners by American underwriters acting as principals of foreign equity or debt issues (sec. 4919(a)). That discrimination against foreign stock transactions could readily be cured in the bill as passed by the House, by removing the restriction of section 4919(a) (3) to debt obligations (p. 51, line 4), so that paragraph (3) would become applicable to both stock and debt obligations, in language substantially as follows (deletions shown in brackets):

SEC. 4919. SALES BY UNDERWRITERS AND DEALERS TO FOREIGN PERSONS

(a) CREDIT OR REFUND.—The tax paid under section 4911 on the acquisition of stock or debt obligations of a foreign issuer or obligor shall constitute an overpayment of tax to the extent that such stock or debt obligations—

* * * * * * *

(3) [Certain Debt Obligations.—
Consist of debt obligations acquired] Acquired by a dealer in the ordinary course of his business and sold by the dealer to persons other than United States persons within 90 days after [or, in the case of short sales, within 90 days before] their acquisition.

Equivalent change would be made in the revised version of section 4919 as proposed in "Amendments Recommended by the Treasury Department," page 29.

It is noted also that the Treasury Department in its recent suggested amendments (p. 30) recommended a limited exclusion from tax liability of arbitrage activities on exchanges. But the proposed change would allow a credit or refund only where a dealer sells foreign stock to a foreign person on the same day the stock is purchased. The 1-day limitation would not cover certain arbitrage transactions between Toronto and London since securities purchased on a Canadian exchange cannot always be sold on the same day on the London exchange due to time differential.

Transactions among foreigners in foreign stock, arranged in the regular course of our Canadian dealer operations, do not represent an outflow of American capital, do not affect U.S. balance of payments, and imposition of the tax would not further the objectives intended to be achieved by H.R. 8000.

Secretary Dillon has explained that the purpose of the tax is not only to limit access of foreign issuers to U.S. securities markets, but also to increase the efficiency of foreign markets and facilitate and encourage the placement of foreign issues abroad. There is a peculiar interrelationship between the United States and Canadian capital markets already recognized in the provisions of the bill authorizing the President to grant exemption to Canadian issues. To drive our firm from the Canadian market by effectively prohibiting domestic partnerships from acting as dealer among foreign buyers and sellers would seem contrary to the avowed objectives to strengthen foreign markets.

I fail to understand what justifies the discrimination in subjecting equity securities to the tax and excluding debt securities where the parties on both sides of the transaction are foreigners. Secretary Dillon, in a statement before the Ways and Means Committee on August 20, 1963, in defense of subjecting stocks to the tax, pointed out that the issuance of equities is an alternative to debt financing in raising capital, and for many investors bonds and stocks represent alternative use of funds. He concluded that it would clearly be inconsistent to tax "foreign access to one market and not to the other." It is as clearly inconsistent, I submit, to excuse from the tax transactions by underwriters and by dealers in debt securities, as the bill now does, and impose the tax on sale of equity securities by a dealer in similar circumstances. Again in explaining why dealers maintaining markets among foreigners in foreign bonds would be excused from tax, Secretary Dillion said that—

> this treatment will provide incentives to place a maximum portion of new flotations in foreign hands and will assure potential foreign buyers that an active secondary market will be available for such new foreign bonds as they may purchase.

The same incentives and the same encouragement offered to foreign debt securities should be made available to the dealer transactions we carry out through our established Canadian office in purchasing foreign stocks from foreign sellers and selling them to foreign buyers, exclusively for Canadian dollar accounts on both sides.

The Committee on Ways and Means in its report has stated that:

The bill provides for exemptions for various transactions in order to avoid creating unnecessary hardship and impairing normal commercial transactions.

An exemption for transactions by a foreign branch office between foreign buyers and foreign sellers would be consistent with the purpose to avoid unnecessary hardship and impairment of normal commercial transactions. The effect of imposing the tax would be to distort normal market relationships as carried out by established U.S. dealers in Canadian and other markets, and to weaken instead of strengthen foreign markets as sources of capital funds in the form of equities.

Senator DOUGLAS (presiding). Mr. King, since I am the only member of the committee left, I will not be interfering with the other obligations of other members of the committee if I ask you a question or two.

Mr. KING. Yes.

Senator DOUGLAS. And if you have leisure to respond I would appreciate it.

You say:

The bill in its present form harshly discriminated against our Canadian dealer transactions.

I had thought that the Treasury Department and the administration had given a virtual pledge to exempt Canada from this bill, I therefore was not quite able to understand why you did not take this pledge as being binding.

Mr. KING. The exemption covers, of course, new issues of bonds and stocks. If we participate in, as an underwriting group in Canada, a new issue we would be exempt from the tax as long as the securities are sold to other nonresidents or other foreigners, and that applies to both public issues and to private placement.

Both stocks and bonds are included in that exemption. Well, they make a third exemption for normal trading in securities, but they restrict it only to bonds.

Senator DOUGLAS. You mean trading in existing issues?

Mr. KING. That is in any issue.

In other words, they don't restrict the trading afterwards to new issues.

In other words, if we wanted to buy $10 million worth of bonds there would be no tax unless we kept them for more than 90 days.

Senator DOUGLAS. Do you wish to have that extended to stocks?

Mr. KING. Yes, we feel that in order to, not to interrupt our regular business which we have carried on for the last 20 years, we should have the same privilege.

We in our operations in Canada maintain active markets in 75 or 100 different issues. They may be secondary markets or they may be existing issues and that has been our business.

Our Canadian office buys and sells them and sometimes they keep them for a few days and sometimes they sell them out the same day, but to limit it to give us no time at all, we just have to discontinue the business. There are no specialists on the Toronto Stock Exchange, and we have for many years acted in the capacity of a specialist.

Throughout the day we will continue to make markets in local securities for other dealers to sell to us, and we serve them, we serve a similar purpose to what specialists do on the New York Stock Exchange and the American Stock Exchange and it is for that purpose we think we are being discriminated against and we cannot see where there is really any harm as far as the balance of payments is concerned because if we buy them and we don't sell them within 90 days we are still subject to the tax and there are no foreign dollars involved. It is purely Canadian dollars, and it doesn't seem right to give the privilege of buying unlimited debt or bonds in the course of trading to one segment of the industry, and denying to the other section of the industry the right to even buy 10 shares overnight.

Senator DOUGLAS. In existing issues or in outstanding issues?

Mr. KING. That is in the outstanding issues.

Senator DOUGLAS. Is there a representative of the Treasury in the room?

I wonder, sir, if you would come forward to the table here. Would you be kind enough to identify yourself?

Mr. ROTHKOPF. My name is Arthur J. Rothkopf. I am with the Treasury Department.

Senator DOUGLAS. I wonder if you would state the Treasury position on this point as to whether any adjustment should be made.

Mr. ROTHKOPF. I think, Senator, I would refer to page 30 of the suggested amendments which were proposed by the Treasury to H.R. 8000.

Senator DOUGLAS. I wonder if Mr. King and his associates would check it?

Mr. ROTHKOPF. Page 30. In that provision, which would add a new credit or refund provision to section 4919 of the bill it is provided that if a dealer in securities acquires foreign stocks in the ordinary course of his business, and sells those stocks to a foreigner on the date of purchase then he would be entitled to a credit on that particular purchase.

Let me make this point initially. The bill as it passed the House contained only a 90-day provision for outstanding trading in debt obligations. It contained no stock provision at all.

Mr. King's firm, which specializes in arbitrage activities, and another securities firm which also specializes in such actvities, brought this matter to our attention, and indicated that their arbitrage activities between the United States and Canadian exchanges would be adversely affected.

Senator DOUGLAS. Because they could not be effected in 1 day?

Mr. ROTHKOPF. They could not be effected. Under the provision as it passed the House there was no way at all in which they could arbitrage foreign stocks because there was only a provision available as to bonds and there was none as to stock.

Senator DOUGLAS. Would you be agreeable to having stocks included in the arbitrage provision?

Mr. ROTHKOPF. We have proposed, Senator, such a provision. This proposal is a new provision, and will now give a same day rule as to stocks.

Senator DOUGLAS. Could you extend that to 2 days?

Mr. ROTHKOPF. Well, I think 2 days would sound like it would be reasonable and we think that would probably cover most arbitrage

transactions. As Mr. King has pointed out, there could possibly be a situation where there is a purchase, say, in New York and sale in London and they might have some difficulty in doing that on the same day. Or in addition it has been pointed out that a purchaser may not find out what he bought until the close of the particular day and, therefore, he could not sell that stock on the same day and would have to sell the next day.

Senator DOUGLAS. I wonder if Mr. King's associates would transmit this proposal to him: that this period be extended to 2 days to overcome the time difficulties.

Mr. KING. That would help in connection with international arbitrage between here and Canada, but what we are talking about are the transactions which are done locally between foreigners in Canada, both the buyer and the seller, that have nothing to do with arbitrage in this country.

Some of these transactions would have to do with international arbitrage between our Canadian office and London, but it would not affect the United States at all. It would not be involved.

I think that the 1- or 2-day clause that Mr. Rothkopf is talking about is foreign securities which are dealt in in the United States, between the United States and a foreign country.

Our particular problem is our activities locally between Toronto and Montreal or Toronto, trading between Toronto and Montreal or Toronto and Vancouver or Toronto and London. It does not affect New York at all. It is purely a local offshore business, you might say. It does not involve any U.S. dollars or affect the balance of payments.

Those are the ones we are particularly objecting to.

Senator DOUGLAS. I confess that I certainly do not understand all the complexities of this problem. But I had not thought that our act reached out to encompass transactions within foreign countries.

Mr. ROTHKOPF. Senator, if I might point out here, I think one of the difficulties that is involved is that Mr. King's operation in Canada is a branch operation.

In other words, his branch office in Toronto is part of his New York office, and since his is a New York State partnership, as I understand it, therefore, any purchases which would be made anywhere, whether it be in Canada or in London or anywhere else by Charles King & Co., which is a New York State partnership, would be an acquisition by a U.S. person and be subject to the tax.

Any other result would open up terrific opportunities for evasion.

Senator DOUGLAS. Insofar as Canada is concerned are you opposed to extending to stocks the exemption now accorded to bonds, other than with respect to lengthening the period of arbitrage?

Mr. ROTHKOPF. Well, our position is, on the Canadian exclusion is that it is strictly limited to new financing here in the United States and should not be extended to trading in outstanding securities. Certainly for the purposes of financing the Canadian balance of payments there would be no advantage to exempting outstanding securities.

We would not be in favor of that.

Senator DOUGLAS. Would you repeat that again? Those words are deceptive.

What is that that you favor?

Mr. ROTHKOPF. Well, we do not——

Senator DOUGLAS. What is it you do not favor?

Mr. ROTHKOPF. We do not favor extending and in fact our proposal, the provision in the bill as to Canada or as to international monetary stability, would extend only to new Canadian issues.

Senator DOUGLAS. That is the exemption.

Mr. ROTHKOPF. The exemption would extend only to new Canadian issues, that is correct.

Senator DOUGLAS. To the degree that you have an excess of American purchases of outstanding issues over Canadian foreign purchasers of American securities, this creates a claim against the United States. This you propose to maintain, is that right?

Mr. ROTHKOPF. That is correct.

Senator DOUGLAS. That is, you propose to maintain defensive measures?

Mr. ROTHKOPF. With respect to outstanding securities, that is correct.

Senator DOUGLAS. Yes, that is right.

Mr. ROTHKOPF. There would be no exemption available for outstanding Canadian securities.

Senator DOUGLAS. And the most that you want to concede is the time factor on arbitrage.

Mr. ROTHKOPF. That is correct.

Mr. KING. As I understand it, the way the bill reads is that certain debt obligations—the paragraph reads—debt obligations acquired by a dealer in the ordinary course of his business and if such securities are sold within 90 days he gets a tax credit.

Now, there is no limitation here to any particular type of bond. It just says a debt obligation, and it could cover any kind of bond. Mr. Rothkopf has pointed out that it pertains particularly to the secondary market in new issues but is certainly doesn't say so in the bill, and in proposing the change, it was said here that this proposal does not contain a 90-day provision as in the case of bonds, that is the 1-day allowance, it does not contain the 90-day provision in the case of bonds because of the possibility that a broad dealer exclusion in stocks would become a tax-free vehicle for speculation in foreign securities.

That is on page 30, on the third, lower part of the third paragraph.

Why there should be more speculation in stocks on a 3-month basis that can be done in bonds, is just something which just doesn't make sense.

Senator DOUGLAS. You mean no more speculation in stocks than in bonds?

Mr. KING. Because if anyone is going to make wild speculation, to uncover within 3 months he has really got to be very, very clever.

Senator DOUGLAS. I had never thought that the purchase of bonds was as speculative as the purchase of stocks. I see people nodding their heads. I don't know whether they are approving my statement or contravening it, but I always thought that bonds were more or less the first claim upon earnings and were thus far more secure than stocks which had residual claims. Residual claims fluctuate much more sharply, of course, than prior claims.

Mr. ROTHKOPF. Senator, if I might point out why in the first instance this provision was put in for debt obligations, I think it goes to the point which you are raising, and that was that we did want to assure that in those cases where obligations were sold in Europe, which we, of course, are trying to encourage that there still would be an active U.S. market for those debt obligations and it was felt that this 90-day bond provision would very heavily contribute to that result.

Senator DOUGLAS. At least would you consult with your principals and see whether you would agree to a 2-day extension on arbitrage?

Mr. ROTHKOPF. Yes, I certainly would do so, sir.

Mr. KING. On the same principle if it is good for a secondary market to be continued for bond transactions why isn't it good for a secondary market to be continued in stock transactions that you are floating in foreign countries, it is very inconsistent.

Senator DOUGLAS. I know you won't expect me, at 1:25 in the afternoon, to settle all those questions.

We have won at least a small concession for you; the larger issue can be fought out later.

We will resume tomorrow morning at 10 o'clock.

(Whereupon, at 1:25 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, July 1, 1964.)

INTEREST EQUALIZATION TAX ACT

WEDNESDAY, JULY 1, 1964

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10:10 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd (presiding), Douglas, Talmadge, Carlson, Bennett, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The first witness is Nathaniel Samuels, Investment Bankers Association of America.

STATEMENT OF NATHANIEL SAMUELS, CHAIRMAN, FOREIGN INVESTMENT COMMITTEE, INVESTMENT BANKERS ASSOCIATION OF AMERICA

Mr. SAMUELS. Mr. Chairman, members of the committee, I am Nathaniel Samuels, a partner in Kuhn, Loeb & Co. and chairman of the Foreign Investment Committee of the Investment Bankers Association of America.

I am appearing before you to express our views in opposition to the proposed Interest Equalization Tax Act of 1963. A supplementary statement has been filed by us with your committee which sets out the position of our association in more detail than is possible in limited oral testimony.

I am aware that this committee has been deluged with voluminous statistical data and highly sophisticated analyses of our balance-of-payments position, and I am cognizant of the fact that much of the data is susceptible to quite different interpretations in the minds of different people, even when all of them are straining their efforts to be objective. Instead of adding further to this element of the exercise, and since our written statement sets out the details of our position, I shall confine my remarks to two general considerations. First, I would like to question the timeliness of enacting into law controls over capital movements at this moment in the evolution of our balance-of-payments position. Second, I would like to say a few words about the practical side of the international capital market, as seen by some of us who are in the investment banking business, and thereby examine the question as to whether H.R. 8000 is really responsive to the problem.

As to the first consideration, July 1964 is not July 1963. The effective closing down of the U.S. market for foreign investment after July 1963 was, no doubt, an important contributing factor to the reduction of our deficit in the last quarter of that year. However, our deficit further declined sharply in the first quarter of 1964, so that our payments position was virtually in balance in that quarter. This occurred despite the sharp increase in bank loans subsequent to the announcement of the interest-equalization tax, an increase which has in effect nullified the decline in outflow from foreign securities transactions as a consequence of the interest-equalization tax.

Obviously, the improvement this year had to be due to other causes than the interest-equalization tax. It appears that the improvement in our trade surplus was the main reason for our better performance.

While there may have been some unusual, perhaps nonrecurring elements in the expanding trade surplus, the course of events within the past year has revealed what perhaps was less clearly discernible 12 months ago; namely, that significant economic forces which had been acting adversely to our balance of payments in recent years have now reversed their course and are acting in our favor. This raises the question whether the enactment of H.R. 8000, whether or not it had any justification in July 1963, would be timely and appropriate today.

While our exports have been rising sharply and our imports have thus far remained relatively stable, Europe, on the other hand, has been, in general, experiencing fairly stable exports but sharply rising imports. This is evidenced by the fact that the six nations of the European Economic Community, which enjoyed a combined trade surplus with other countries 5 years ago of $1 billion, suffered a deficit at the end of 1963 of about $3 billion. In the first quarter of this year, their trade deficit was running at the annual rate of $4 billion. The reversal in the U.S. and European positions has been going on for some time, but these underlying trends have been picking up in momentum and have become more evident during the past year.

If we turn briefly to some of the causes of this, we find that price and wage levels in various European countries have been soaring in the past 2 or 3 years, while in the United States we have maintained relative stability.

On the other hand, growth rates in the United States are rising, while rates of growth in Europe have recently been slowing down. U.S. direct investment in Europe has slackened somewhat, and tax reduction should make investment in the United States, when coupled with an increasing growth rate, relatively more attractive than investment in Europe.

Without going more deeply into economic forces now at work and why they are acting as they do, we see a picture of inflation and slower growth in Europe as contrasted with relative stability and increased growth in the United States. We can very well understand that the Bank for International Settlements, in its latest annual report, remarks that—

> Following the signs that were evident a year ago, the trouble spot in the economic picture shifted to continental Western Europe during the past 12 months.

These changes in the economic picture begin to impart reality to some of the trends which were foreseen in the report of the Brookings

Institution in August of last year on the evolution of the U.S. balance of payments.

Speaking as citizens and as objectively as we can, we are quite aware that one cannot project these improvements in our position as absolutes. Admittedly, all economic indicators do not act in unison to suggest that one set of economic or financial policies is clearly called for as against another set. There are always conflicting tendencies, and action is often a question of emphasis or timeliness. We can well understand the difficulties of our responsible officials who must often act on not too clearly discernible probabilities or who must necessarily act within the context of political realities as they exist at any given moment, regardless of whether these may coincide with the most efficacious economic and financial policies. However, we are of the opinion that, on balance, there does not exist such a clear and present danger to our balance-of-payments position as to justify a reversal in the historic American policy of freedom of capital movements. We are strongly of the opinion that the maintenance of our policy of freedom of capital movements is of such enormous relevance to our position of free world leadership that we should, under present circumstances, await further developments in the balance of payments before undertaking such a reversal in policy as embodied in H.R. 8000. It seems to us, moreover, to be inconsistent and untimely to impose such controls at a moment when we are vigorously advocating further liberalization in trade and urging other countries to remove their remaining barriers to movements of goods and of capital.

In addition, we strongly urge adoption and implementation of various measures recommended in the task force report to the President on promoting increased foreign investment in U.S. corporate securities and increased foreign financing for U.S. corporations operating abroad. These measures would materially help our balance-of-payments situation.

This brings me to my second consideration, which I shall touch on briefly; namely, whether H.R. 8000, from a practical point of view, is responsive to the problem of restricting long-term capital outflow for portfolio investment.

Apart from Canada, hardly any private foreign lending by Americans occurred after World War II until about 6 to 8 years ago. A certain number of foreign dollar issues began to take place at that time, but the interest of American investment institutions in purchasing them was extremely small indeed. We were able to place perhaps 10 or 15 percent, possibly 25 percent of an issue with American investors, and had to sell the bulk of each issue to European investors. Gradually, because of the exhortations of the U.S. Government urging private investment abroad and because such investment became more attractive as conditions abroad improved, the proportions of sales to American investors on new public issues in the year or two prior to the interest-equalization tax rose, by and large, to around 50 percent. There were, of course, variations of these percentages on particular issues. The net impact on our outflows from public issues was, therefore, much less significant than the total outflow figures would lead one to believe.

Europeans generally prefer to buy securities which are listed on stock exchanges and are marketable and, accordingly, they have not

ordinarily participated in private placements. Thus, private placements, particularly in the past year or two, have hit the American balance of payments with full impact. For example, there was one private placement alone in 1962 of $250 million and another in 1963 of $300 million.

If in the future it becomes necessary to adopt legislation which would limit the impact of new dollar issues on our balance of payments, such legislation should not be such as to discourage access to our market, but to permit use of our market under conditions that will continue our earlier postwar pattern of maximum sales to investors outside the United States. We believe that there would be no difficulty in designing a measure which would enable our market to absorb a reasonable and readily sustainable portion of publicly offered foreign dollar issues, and which would have the effect of minimizing the magnitude of private placements.

The role of Europe is further illustrated by what has taken place subsequent to the announcement of the interest-equalization tax. The new issue business formerly handled in New York has shifted to Europe, primarily to London, even though hardly any appreciable amounts of the bonds offered by the London houses are purchased by British investors, because of the approximately 12-percent dollar premium currently payable by United Kingdom residents. The bonds are sold largely to investors on the Continent, generally to the purchasers to whom we were selling foreign dollar bonds.

The consequence is, therefore, that the British, and to some extent others on the Continent, have taken over the business formerly handled in New York and are earning the foreign exchange for such services formerly earned by us.

I need hardly reiterate that to the extent that there is an outflow of dollars by Americans for purchases of foreign bonds, these dollars are repaid in accordance with prearranged schedules, together with interest earned thereon. In the case of equity securities, we have been acquiring valuable earning assets abroad, the dividends and profits on which have added to our foreign exchange earnings, and which investments can be repatriated when sold. This is not the case with much of our other major dollar outflows.

To sum up, if the economic trends which are now running in our favor should again reverse themselves, and if we should encounter a severe deterioration in our position which calls for emergency action, we of the investment banking community would be prepared to cooperate with the Treasury fully and promptly to combine our efforts in devising means to meet their requirements and yet not do severe and lasting damage to the American capital market. If the Executive and the Congress were to deem it essential to take action in lieu of H.R. 8000, we believe that measures can be devised which may be more flexible, appropriate, and less harmful.

I would like, in this connection, to say that we have cooperated with the Treasury and the Treasury with us in clarifying certain procedures under H.R. 8000, and in working out several amendments to the bill. Counsel for the IBA has worked closely with the Treasury in connection with the amendments which the latter has submitted to your committee. These amendments, however, do not go to the substance of the proposed law. Also, I would like to add that the Treasury has helped

recently in various ways to make it possible for American investment banking houses to continue to carry on the new issue business insofar as it involves the sale of issues outside of the United States. We value this cooperation.

Thank you very much for your time and your kind consideration.

(The supplementary statement by Mr. Samuels follows:)

SUPPLEMENTARY STATEMENT SUBMITTED BY NATHANIEL SAMUELS, CHAIRMAN, FOREIGN INVESTMENT COMMITTEE OF THE INVESTMENT BANKERS ASSOCIATION OF AMERICA

The Investment Bankers Association of America has a membership of 744 firms throughout the United States which underwrite and deal in securities, essentially domestic and to some extent foreign. These firms have over 2,000 officers throughout this country and in various cities abroad. Our business is primarily that of raising capital funds for industry and for States, cities, towns, and governmental agencies in the United States and to a certain extent for like entities outside the United States. As a measure of our activity, investment bankers in the United States raised over $20 billion of capital funds in 1963. Our members also play a significant part in the secondary market for all such securities, both on the stock exchange and over the counter.

Because of our business, we have a unique knowledge of the interaction between foreign capital markets and those of the United States, and a special stake in the preservation of the soundness of the U.S. dollar and the strength and freedom of its capital market.

Almost 1 year has elapsed since the interest equalization tax was first proposed. The economic developments in the course of that year have placed us, today, in a better position to assess the need for legislation to improve our balance of payments and specifically the desirability of the interest equalization tax as a means to that end.

In August 1963, the Investment Bankers Association testified before the House Committee on Ways and Means in opposition to the proposed interest equalization tax. We stated then that it was our considered view that the proposed tax was inconsistent with the long-term interests of the United States and one which entailed adverse consequences outweighing any short-term benefits to the U.S. balance-of-payments position. The events of the past year have served to confirm our confidence in the correctness of our position.

Before presenting the substance of our objections to the proposed bill, let us review the marked improvement in the U.S. balance-of-payments position during the past year and atttempt to analyze the contribution made by the interest equlization tax to this improvement. Let us consider for this purpose the first quarter of 1964, the most recent period for which the figures are available, as compared with the comparable period of 1963. The U.S. balance of payments has been improving since the second quarter of 1963. Payments for regular transactions for the first quarter of 1964 were virtually in balance, reflecting a surplus of $68 million, or as seasonally adjusted a deficit of $181 million, as compared with a deficit of $813 million, or $1,180 million as seasonally adjusted, for the first quarter of 1963. This marked improvement over the comparable period for the preceding year appears to be largely attributable to an increase in our net trade balance (the excess of U.S. merchandise exports, excluding military, over U.S. imports) for the respective periods from $967 to $1,740 million, as seasonally adjusted, an increase of $773 million.

Of course one quarter can be affected by special factors, and trends only clearly emerge over longer periods, but the figures for the 9 months ended March 31, 1964, as compared with the comparable period of the previous year, present much the same result showing an improvement in the net trade balance of $1,372 million, as seasonally adjusted. The year 1963 showed an improvement in net trade balance of $565 million over 1962.

There is thus increasing reason to believe that the predictions of the Brookings Institution study, "The United States Balance of Payments in 1968," and the material assumptions on which these predictions were based are essentially sound. This study concluded that basic economic forces would prior to 1968 bring about an elimination of the basic deficit in the U.S. balance of payments, without the necessity of resorting to measures restricting capital movements.

Among the factors relied upon by the Brookings Institution study was the expectation of improvement in the relative cost position of the United States. Inflationary pressures in a number of European economies such as Italy, Switzerland, and France have developed even more rapidly than was foreseen at the time the study was published. Such pressures affect the volume of European production available for export and ultimately must be reflected in increased export prices. If we do not allow our own economy to overheat, the net result is an improvement in the U.S. competitive position in the export markets.

Investment bankers would certainly be the last to deny that the proposed interest equalization tax significantly affected a number of items entering into our balance of payments in the first quarter of 1964. Its impact upon our business has been sharp indeed. But the net effect of the bill is not readily determinable. Even if it were, it would not follow that enactment of the bill would perpetuate the effect. Among other things, the proposed exemption for Canadian new issues, which alone amounted to $457 million in 1962 and $730 million in 1963, has not yet become operative.

Moreover, as Secretary of the Treasury Dillon has himself recognized, the initial impact of the tax has been exaggerated by a tendency to postpone action pending legislative resolution of the proposal. The fact is that the uncertainty engendered by the threat of the enactment of a restrictive tax has in effect imposed not merely a limitation but a virtual embargo on the sale of new foreign issues in the U.S. market. The U.S. capital market for new foreign issues has for all practical purposes been closed down by executive fiat for an entire year.

Bearing in mind, therefore, that the effect of the tax can be expected to be somewhat different, if and when it is imposed, let us attempt to discern what the effect of the proposed tax has been. In the first quarter of 1964, U.S. purchases of new issues of foreign securities amounted to $132 million and U.S. transactions in outstanding foreign securities represented net sales of $99 million, resulting in a net capital outflow from U.S. transactions in foreign securities of $33 million. The comparable figures for the first quarter of 1963 were a net capital outflow of $481 million as a result of U.S. purchases of new issues of foreign securities, and of $59 million as a result of net U.S. purchases of outstanding foreign securities, or a total net capital outflow of $540 million. On the other hand, U.S. bank credit to foreign persons which represented a net inflow of $105 million in the first quarter of 1963 changed to a net outflow of $634 million in the first quarter of 1964, a total adverse change of $739 million. It would thus appear that foreign persons have to a considerable extent resorted to credits with U.S. banks to finance the imports and capital investment that were previously being financed by securities issues. If this should turn out to be a principal effect of the bill, one may well ask if the damage it causes to the free capital market is warranted.

It is also interesting to note that foreign purchases of U.S. securities contributed $14 million as a capital inflow in the first quarter of 1963, but in the first quarter of 1964 transactions by foreigners in U.S. securities represented net sales or a capital outflow from the United States of $42 million. This reversal suggests that the ability of foreigners to purchase U.S. securities is to some extent dependent on the funds made available by U.S. persons in purchasing foreign securities.

We recognize that the U.S. balance-of-payments position is one that requires vigilance and despite manifest improvement is likely to continue to require vigilance. However, the long-term position and outlook is essentially strong.

In our opinion the situation which the United States faces today is quite different from that which existed when the interest equalization tax was conceived and proposed. Given the strength of the economy today, in part as a consequence of the reduction of personal and corporate income taxes, we believe that even if the interest equalization tax were not imposed, the volume of U.S. investment in foreign equity securities would be at substantially lower levels than prevailed a year and a half ago. The prospects and opportunities at home are relatively brighter and those abroad relatively less inviting than was then the case.

It is difficult to predict what level of net U.S. investment in foreign debt securities would exist today if the interest equalization tax were withdrawn. It is our belief that the level which existed in the first half of 1963, an annual rate of $2 billion a year, was due to unusual circumstances not present to the same degree

today. But it would be reasonable to expect that foreign issues, which as a practical matter have been barred by the proposed tax, would resume at a substantial level.

In our opinion this resumption of foreign issues should not be a matter of great concern. As discussed above, it would appear that since the tax was proposed bank credit has to a considerable extent replaced security issues as a means of extending credit to foreign borrowers. A resumption of security issues would undoubtedly be accompanied by substantially lower levels of bank credit to foreign borrowers. Moreover, nearly two-thirds of the new issues in the first half of 1963 were Canadian or Japanese issues. Very likely this would be equally true today. These two countries are not in a position of accumulating dollar reserves. Both countries have very large trade deficits with the United States which they cannot long continue without resort to U.S. capital. Trade follows credit. Every dollar they obtain quickly finds its way back to the United States.

As Prof. Emile Despres of Stanford University, the coauthor of the Brookings Institution study, stated in his testimony before the congressional Joint Economic Committee on July 29, 1963, with respect to the effect of the proposed tax as applied to Canadian and Japanese securities:

"* * * it probably won't help our balance of payments, and indeed it may have the opposite effect because Japan and Canada are countries that have operated on rather modest reserves relying upon the United States, being financially dependent upon us in a sense to tide them over balance-of-payments difficulties.

"To the extent that it causes them to feel that this is no longer available to them as readily, it may cause them to adopt economic policies which will result in the holding of larger reserves, probably at the expense of the U.S. reserves. In other words, the adaptations which these countries will make to less ready access to our capital markets are likely not merely to compensate but to overcompensate, and therefore the balance-of-payments advantage when we try to apply it to countries like Canada and Japan is likely to be nil or negative."

It must be kept in mind that while capital outflows from portfolio investment in foreign securities can proceed at a rate that places a temporary strain on U.S. balance of payments, as we now calculate and report them, such investments in themselves are unquestionably a source of strength to the dollar in the longer term.

Investment in portfolio securities is only one, and by no means the largest, of a number of categories of expenditures that result in outflows of U.S. dollars. Other principal categories are direct investment, bank loans, military expenditures, foreign aid, imports, and tourism. Portfolio investment is moreover a form of expenditure which increases U.S. assets. This is not true, for example, for expenditures such as military aid and tourism. Not only do the dividends, income, and repayment of principal on portfolio investments contribute significantly to U.S. current receipts, but the assets themselves are ultimately additional reserves supporting the dollar. Since 1950, the first postwar year in which a deficit in U.S. balance of payments appeared, total U.S. assets and investments abroad (including direct investment) have increased from $32 billion to more than $80 billion, while foreign assets and investments in the United States have increased from $18 billion to some $47 billion. Thus the overall U.S. net asset position has improved from $14 billion to more than $33 billion.

As we report our balance of payments, short term foreign assets owned by U.S. private citizens are not reflected, even when held in countries with convertible currencies. All that is shown is the contribution to the deficit made by net acquisitions or to the reduction of the deficit made by net sales of these assets during the accounting period. It is perfectly true that a gradual reduction in oversea assets held by American citizens will help to carry a balance-of-payments deficit during the period in which the reduction is taking place, but on any realistic appraisal the dollar is being weakened by the exhaustion of such assets and strengthened by their acquisition. It is precisely analogous to a man drawing on his savings to meet current expenditures. You will recall the effect on Great Britain's balance of payments as a result of her utilization of oversea assets to meet costs of World War II.

The Investment Bankers Association believes and respectfully suggests that under the changed circumstances which the United States faces today your committee should not approve the Interest Equalization Tax Act but should await further developments. If the basically favorable trend in our balance of payments does not continue, the situation can be reconsidered. If it seems advisable, the Treasury Department could then explore with our association and

like groups measures which will not discourage access to our markets but will permit use of our markets under conditions that would limit the impact of new dollar issues on our balance of payments.

We have opposed the proposed tax since we believe that it will adversely affect the U.S. balance of payments in the long run.

In addition, there are five other basic reasons why we believe the tax to be ill advised:

1. *The proposed tax is not addressed to the fundamental causes of the balance-of-payments deficit.*—To reduce significantly our balance-of-payments deficit we must get at the real bases of the dollar outflow: (*a*) We must lose no opportunity constructively to continue to reduce the direct dollar drain ($1.9 billion net in 1963) from military expenditures abroad; (*b*) we must make greater progress in relating foreign economic assistance (which adversely affected the balance of payments to the extent of about $900 million in 1963) to expenditures of dollars in the United States and in persuading other developed countries, especially those which are reserve accumulating, to assume a large share of foreign assistance programs; (*c*) we must continue to improve our cost position in relation to our competitors abroad; and (*d*) we must increase the attractiveness of foreign direct and portfolio investment in the United States by constructive measures such as those suggested by the Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad.

Until such basic measures take effect, the United States is by no means without resources for meeting the dollar drains to which it is subject. They consist of (*a*) official holdings of gold and foreign exchange; (*b*) formal "swaps" of currency or similar bilateral arrangements; (*c*) the issuance of special certificates and bonds denominated in the currency of the creditor country; and (*d*) access to the International Monetary Fund.

These resources provide defenses that permit a deficit country to deal with substantial pressures without imposing new restrictions, and to apply the basic corrections that are needed to bring international payments into reasonable balance. Moreover, if any more drastic temporary measures were required, we would question whether interference with asset-creating portfolio investment abroad is warranted when no significant steps have been taken to reduce non-asset producing private expenditures, such as American tourists' expenditures in foreign countries (which amounted to nearly $2.7 billion in 1963).

2. *The proposed tax is a new protective tariff on capital transactions and is inconsistent with our longstanding policy of freedom for capital movements.*—The proposed tax would be more accurately described not as a tax at all but rather as a new protective tariff to limit the importation of foreign securities or, viewed from the opposite point of view, as a duty on exports of private capital for portfolio investment abroad. So viewed, the so-called tax represents a new barrier to the free international movement of capital and a retreat from the policy of maintaining and advocating the free flow of capital across national borders.

3. *The U.S. capital market, and foreign economies dependent upon it, may be seriously damaged.*—The position of the United States as the only free capital market in which the amount and terms on which an issuer can sell its securities are limited solely by the marketplace is a precious national asset which should not be dissipated without convincing reasons of national interest. Because of this position, the United States has in effect become the banker for the free world and has attracted a large volume not only of domestic U.S. capital but also of foreign capital.

As a result of the tax U.S. investment banking firms have forfeited established relationships with foreign issuers built up at great expense and with extended personal effort over the years. The resulting loss in underwriting fees and commissions represents a drain on our balance of payments. In many cases, particularly in the case of European issuers, the greater part of the issues in respect of which such fees were earned, were sold in Europe by the American underwriters so that not even a temporary benefit in the balance of payments has been achieved.

4. *The proposed tax creates fears of further restrictions.*—The United States today is the leading financial power of the world. We all want it to remain so. Part of the responsibility and obligation of being the leading financial power of the world—of being the banker to the world and of having the key currency which is widely recognized as a standard of value and widely used in world trade and finance—is to keep our currency strong and free from restrictions on its use.

We must not, through one device or another, impair the value of the dollar as the key currency of the world or create fears that further restrictions may be imposed.

5. *The proposed tax is discriminatory.*—The proposed tax is broadly discriminatory since it selects only one aspect of private expenditure abroad; namely, private portfolio investment, for restriction through a special tariff while leaving unaffected private expenditures abroad for tourism, direct foreign investment, and commercial bank loans made in the ordinary course of the bank's commercial banking business.

6. *The proposed tax is administratively complex.*—It will be applicable not merely at the time of the original issuance of securities but to subsequent nonexempt transactions throughout the life of the tax. Certificates of American ownership must be employed to qualify for the prior American ownership exemption and transactions even in foreign securities qualifying for this exemption must be reported in quarterly tax returns. Compliance and enforcement procedures will prove burdensome both for the security dealers of the Nation and ultimately for the Treasury itself. Policing compliance, particularly where bearer securities are involved, may be exceptionally difficult.

The Investment Bankers Association believes that the proposed Interest Equalization Tax Act should not be enacted. Any probable short-term beneficial effects fall far short of justifying the adverse consequences. It is most injurious to the U.S. international capital market, a national asset to be fostered rather than injured. It imposes hardships on our friends abroad that over the long term can only be detrimental to us as well.

Our long-term balance-of-payments position and outlook is strong. It would be better to deal with our present problem by improving our international competitive position, encouraging increased foreign investment in the United States, reducing our non-asset-creating expenditures abroad and even by temporary drawings on the International Monetary Fund or use of our reserves, rather than to endanger the free flow of funds or our position as the world's banker and trustee of the key currency of the world. Once confidence in us and in the freedom of our capital market is impaired, it will be difficult to rebuild it. In any event, the improvement in our balance of payments in the last 9 months would suggest that there is no necessity for enacting so drastic a measure as the interest equalization tax at this time.

Substantive proposals with respect to exemption from interest equalization tax

For the reasons indicated in the first part of this testimony the IBA does not believe that restriction of portfolio investment by U.S. persons through the proposed Interest Equalization Tax Act is either an effective or desirable means of improving the U.S. balance-of-payments position.

If, however, Congress should determine that governmental limitation in this area should be imposed through this means, the IBA strongly recommends that general exemptions be included for (*a*) securities, the proceeds of which are used to pay U.S. persons for goods or services or to repay bank loans for similar purposes; and (*b*) outstanding securities.

1. *Exemption for securities, the proceeds of which are used to pay U.S. persons for goods or services.*—The stated purpose of the Treasury in proposing an interest equalization tax is to limit transactions which adversely affect the U.S. balance of payments. However, financing the purchases of U.S. goods or services does not adversely affect the U.S. balance of payments, whether such financing is effected through commercial bank loans or credit extended by U.S. exporters (both of which are exempted under the proposed act) or through the sale of securities in the U.S. capital market. In fact, the effect on the U.S. balance of payments may be more favorable where the proceeds of a public financing are used for this purpose since in such a case all of the proceeds of the financing are received by U.S. persons while usually a substantial portion of the issue is sold abroad. To this extent the net immediate impact on the U.S. balance of payments is a favorable one and the continuing service of the securities held by U.S. persons will benefit the balance of payments in future years.

There have been numerous examples in recent years of foreign financings for the purposes of financing purchases of U.S. goods and services. For example, in 1959, KLM Royal Dutch Airlines offered and sold in the United States $18,500,000 of 4¾ percent convertible subordinated debentures for the purpose of acquiring jet aircraft from U.S. manufacturers. Of the total amount of this issue, $6,780,000 was sold to European and other foreign purchasers. In 1959 the Italian chemical company, Montecatini, offered and sold in the United States $10

million of sinking-fund dollar debentures (together with warrants to purchase capital stock) to finance the construction in the United States of a chemical plant near Huntington, W. Va. Of the total amount of this public offering $4,115,000 was sold in Europe.

In order to give assurances to the Treasury that the proceeds of particular foreign issues for which the proposed exemption is claimed would in fact be used for purchases from U.S. persons, the following procedures could be adopted:

(a) In the case of securities of foreign governments and government agencies, appropriate officials would certify to the Treasury that the proceeds would be deposited in a U.S. bank and withdrawn only for the purposes of making payment to U.S. persons for goods or services.

(b) In the case of securities of foreign corporations, the same certificate requirement would be prescribed and in addition the full amount of applicable tax plus a penalty of 125 percent of the tax would become payable in the event of noncompliance by the issuing foreign company with its certificate. The foreign corporation and appropriate officers would consent to service of process in connection with any action by the Treasury in respect of noncompliance with the certificate.

Alternatively, although this would increase the administrative costs considerably, it would be possible to provide for escrowing the funds with a U.S. commercial bank subject to withdrawal only to make payments to U.S. persons for goods and services rendered.

The proposal in the "Amendments Recommended by the Treasury Department" transmitted to the chairman of this committee by Secretary Dillon on June 12, 1964, would permit investment banking firms to participate to a very limited extent in the financing of certain defined export transactions. In our opinion this exemption is not sufficiently broad and would only permit investment bankers to participate in a small fraction of export financing in which they might properly participate without adversely affecting the U.S. balance of payments.

Even within its present limited scope this exemption is discriminatory since it only permits investment banking firms to participate in certain of these transactions while permitting U.S. Government agencies and commercial banks to participate in all of them. As a minimum we would accordingly suggest that the amendment recommended by the Treasury with respect to section 4914(g) be changed to read as follows:

"(g) Loss of Entitlement to Exclusion in Case of Certain Subsequent Transfers.—

"(1) In General.—

"(A) Where an exclusion provided by paragraph (1), (B), (2), (3), (4), or (5), of subsection (c), or the exclusion provided by subsection (d), has applied with respect to the acquisition of a debt obligation by any person, but such debt obligation is subsequently transferred by such person (before the termination date specified in section 4911(d) to a United States person otherwise than—

"(i) to any agency or wholly owned instrumentality of the United States;

"(ii) to a commercial bank acquiring the obligation in the ordinary course of its commercial banking business;

"(iii) *to any transferee where the extension of credit by the person originally acquiring such debt obligation was reasonably necessary to accomplish the sale of property or services out of which the debt obligation arose, and the terms of the debt obligation are not unreasonable in light of credit practices in the business in which such person is engaged; or * * *"*

2. *Exemption for acquisition of outstanding securities.*—The proposed exemption for acquisition of outstanding securities should not significantly affect the U.S. balance-of-payments position. Net acquisitions of outstanding foreign securities by U.S. persons (i.e., after deducting acquisitions of foreign securities by foreigners from U.S. persons) amounted to $55 million in 1962 and to $112 million in the first 6 months of 1963; moreover, if transactions in securities of international institutions and Latin American countries (both of which would be exempt from the proposed tax) are excluded there were net sales by U.S. persons (benefiting to this extent the balance of payments) of $36 million in 1962 and net purchases of only $56 million in the first 6 months of 1963.

The Securities Act of 1933 would prevent foreign issuers from using this exemption to effect original issue distributions in the United States. Under

that act, unregistered securities may not be resold in the United States until distribution abroad has been completed and neither the issuer, underwriters, nor selling group members could legally resell unsold portions of the original issue in the United States.

The elimination of the proposed tax on acquisitions of outstanding securities would reduce the disruptive effect on the U.S. capital market since it would permit free trading at price differentials between the United States and foreign markets reflecting only ordinary arbitrage and not any premiums resulting from the tax.

Technical amendments

Representatives of the IBA Foreign Investment Committee and their counsel have conferred frequently with representatives of the Treasury Department with respect to certain technical changes in H.R. 8000 of particular interest to investment bankers. In the event that notwithstanding the considerations expressed above, the Committee on Finance decides to act favorably on the proposed legislation, the Investment Bankers Association endorses the proposed changes contained in the "Amendments Recommended by the Treasury Department," as submitted to the chairman of the committee by the Secretary of the Treasury on June 12, 1964, in the following provisions of H.R. 8000:

A. Section 2(b) of the bill:
   1. Section 4913(a)(3)(A).
   2. Section 4913(a)(3)(B).
   3. Section 4913(c).
   4. Section 4918(f).
   5. Section 4919(a)(1).
   6. Section 4919(a)(2).
   7. Section 4919(a)(3).
   8. Section 4919(b).
   9. Section 4920(b).

B. Section 2(c)(2) of the bill.

C. Section 5 of the bill.

The CHAIRMAN. Thank you very much, Mr. Samuels.

Senator Douglas?

Senator DOUGLAS. Mr. Samuels, I regret that I was not able to be here for the beginning of your testimony. One question has occurred to me, however. Am I correct that under the present bill, American underwriters can sell securities to foreign investors without the payment of the tax?

Mr. SAMUELS. Yes, sir, that is correct.

Senator DOUGLAS. If this is so, how is it that London has an advantage over us in taking issues and selling them on the Continent, as you mention in your statement?

Mr. SAMUELS. Sir, because of the uncertainty pending the passage of the bill and no one being able to know what his liabilities would be if and when the bill were finally passed, plus the fact that the stock exchange in New York has, until very recently, not listed foreign dollar bonds without some distribution in the United States, has made it impossible for foreigners to come to the United States to make these issues, even if the intention were to sell the bonds outside of the United States.

There are various considerations in the mind of the foreign issuer. He often says, "Look, why should I come to New York if you do not sell one single bond in the United States? I might be able just as easily to do that in London or somewhere else on the Continent, where they will distribute these bonds on the Continent, where I can get a listing on their stock exchanges and where the costs are at least competitive with the United States, where I do not have any Securities and Exchange Commission procedures to worry about."

Senator DOUGLAS. But these are not tax considerations.'

Mr. SAMUELS. These are not tax considerations insofar as we sell all the bonds outside of the United States. We have had one issue of that kind, Senator Douglas, since the interest equalization tax, a recent one.

Senator DOUGLAS. In your statement, you say that bonds underwritten by the London houses are sold largely to investors on the Continent. Is this true?

Mr. SAMUELS. This is true.

Senator DOUGLAS. Yet the prospect of a retroactive application of this tax could not be used as a reason for the increase of this business of the London houses, could it, if this is true?

Mr. SAMUELS. Sir, I think if you put yourself in the position of an issuer, he says to himself, "Should I go to New York where, because of the tax, retroactive or prospective, they will not sell a single one of my bonds without my reimbursing the buyer for the tax and, until recently, where I could not even get a quotation on the New York Stock Exchange, and where I might have had to file a registration with the Securities and Exchange Commission, in any case"—because that was not clarified until recently—"Well," he says, "I might as well go somewhere else where I can have them handle my issue, even if certain disadvantages, but without those problems."

You see, if the issuer could sell any part in the United States without tax, even a relatively small part—which is what has often been the pattern of distribution for foreign dollar bonds in this country, except in private placement—if he can do that, then he has a net advantage in coming to the United States. He taps a pool of capital here, however modest, which he cannot otherwise tap. By and large, if he can do that, he would much prefer to come to the United States and list on the New York Stock Exchange, which is far preferable to listing on any other stock exchange. Also, I think it is true to say that, by and large, our European friends feel that dollar issues ought to be done in the home of the dollar—in the United States—if there is any possible way of their doing this.

Senator DOUGLAS. Well, I shall not probe into this more deeply, although I am not at all convinced that your position is sound.

Now the second question I should like to raise. Somewhere in one of your two statements, I think that I read that you thought there had been a great increase in long-term loans to foreign industry given by American banks since this act was proposed. Is that what you said?

Mr. SAMUELS. Yes, I think there has been an increase. I think the banks ordinarily define short-term loans as loans of 1 year or less. In Wall Street we generally refer to loans of 2 to 5 years or thereabout as medium-term loans. I believe there has been a substantial increase in these medium-term loans.

Senator DOUGLAS. I questioned the Secretary of the Treasury very closely on this when the Secretary testified on Monday, inasmuch as this is a form of possible evasion or avoidance of the tax. He entered a denial that this had resulted in more than 5 percent leakage in the balance of payments. Now, he mentioned figures that were somewhat hard to understand at that moment, but I think he is supplying more detailed figures for the record. As I remember, your written statement indicated a very large increase in the long-term, or what you

call medium-term, financing of European enterprises by American banks.

Mr. SAMUELS. I think the figures, if I remember correctly, Senator, given by the Treasury Department indicate that there has been an increase of something over $200 million of so-called long-term loans as one of the components in the sharp increase in commercial bank loans abroad. Just how, I must admit frankly, these various combinations of figures are put together and what they indicate is exceedingly difficult to follow.

Senator DOUGLAS. You are, however, a practical man of Wall Street and you know what is going on.

Mr. SAMUELS. I hope.

Senator DOUGLAS. Is it your general impression that there has been a considerable diversion of the channel for credit to Europe from the purchase of securities as such to the extension of loans by banks?

Mr. SAMUELS. I think, Senator, that the composition and significance of the sharp increase is difficult to assess, and the importance of it can be exaggerated. Obviously, everything I say in answering your questions is personal, not an official position of the IBA, but I am of the opinion that there has been a sharp increase in medium-term lending as part of the increase in commercial bank lending abroad. Those of us who are in Wall Street hear of various instances of this, although what these transactions total up to statistically is always very difficult to ascertain. It is possible that this increase in bank lending may reflect certain nonrecurring factors. We have had increases in agricultural exports, including agricultural exports to Eastern European countries which were financed and may not necessarily recur, and so on. Perhaps bank lending abroad may taper off in the balance of this year.

I think, however, that strange kinds of items enter into this increased lending. There were a few people in Germany, for example, who, 3 or 4 years ago, and perhaps more recently again, felt that because of the German foreign exchange surpluses there might be another revaluation of the deutsche mark.

Well, we certainly have heard of instances where Germans would come here and borrow money simply to have debts in dollars, and through such a hedge would make a profit if the deutsche mark were revalued again. A certain amount of this kind of prudence or speculation, however you might like to regard it, has happened.

What it amounts to statistically, however, I do not know, and I do not know whether anybody knows what this particular figure is when you total up all of it done by the banks.

Some banks do a great deal of ship loan financing. Ship loan financing ordinarily runs 4 or 5 years or so, and that type of thing enters into commercial bank lending which extends beyond short-term trade financing.

We certainly have heard of particular loans which, by the widest stretch of the imagination, have no relation to financing exports directly. I think all dollar outflows help to finance our exports in one form or another, indirectly. However, I would like to add that while the outflow from the banks has largely or essentially nullified the decline in long-term outflows brought about by the interest equaliaztion tax, I do not regard this as necessarily a significant fact with respect to the desirability or undesirability of the interest equalization tax. This increase

may or may not taper off later, and I think the Treasury is right in taking a look-see at this thing to see how it goes beyond this first quarter.

I think the fact that the bank loans have nullified the "benefits" of the interest equalization tax-benefits in quotes—is not a decisive factor as to whether the proposed act is a good act or a bad act.

Senator DOUGLAS. Thank you.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. Mr. Samuels, each of the witnesses that come down to us from the International Investment Market brings us a new idea. The new idea that I get from your testimony is that if this might have been a wise idea a year ago, the change in direction and change in the pattern, both in terms of events in Europe and in terms of our own balance of payments, is such that it may be an unwise idea now. Is that the thrust of your statement?

Mr. SAMUELS. Sir, that is correct. The question is whether, at this moment, when things begin to improve, and perceptively begin to improve, is the time to take action, quite apart from the merits or demerits of the action proposed. Are we fighting this war or the last war—to put it another way.

While no one—I think no one, unless he is a very distinguished economist, might be able to predict how these trends will manifest themselves in another year or so, I do think we can afford to pause at this moment and wait before we do anything new which is so drastic and has all the implications of H.R. 8000.

I think that is the position put simply.

Senator BENNETT. I am interested in your comments about the transfer of business to London. Is it going to be hard to get this back if we pass this law and establish this as the pattern, at least until the end of 1965?

Mr. SAMUELS. Well, this is in the realm of speculation also. I would say this, that it will be hard to recapture the business in the way it was done and to the extent it was done in New York until the interest equalization tax was announced. And, of course, this depends a great deal on a lot of general economic factors, also the extent that issues can be absorbed in Europe, interest rate levels, costs, and one thing or another.

My own feeling about it is that once having reestablished a position on the Continent in handling this business, a certain amount of it is likely to remain there in any case, and this may or may not be a bad thing. I think we are all interested in a further reactivation of the whole capital market mechanism throughout the free world. I do think that once our market is reopened, because it represents the largest pool of capital available, because of the banking structure and mechanism we have, because of the advantages of listing and trading here, a whole variety of things, we probably will recapture a substantial part of that business.

But I do not think things will ever be the same as they were.

Senator BENNETT. Has that damage already been done?

Mr. SAMUELS. The damage has already been done in various ways, both tangible and intangible. The bulk of the business that has been done recently has transferred to Europe and primarily London. Clients we have been serving, governments, corporations, and so forth, have gone to London and have been making issues during the last 9

months, dollar issues, and they are being handled by London and continental houses.

We have not only lost that business which has been done, this has tended to weaken the relationships we have with very longstanding clients in Europe who normally come here for this kind of business.

It has also had a very damaging, intangible effect, I think, on the position of the United States generally. Those of us who are in this business, and we go about and see bankers and various people abroad, primarily in Europe, find that the attitude toward us has changed. I do not think there is any doubt about it. Whereas at one time we represented the world's financial leadership, today we are just one among some others, and with a lot of problems. Our foreign friends tell us quite frankly that from now on we will have to worry about how much paperwork we are going to make them do, and we will have to be sure that our costs are no more and perhaps less than the cost of doing business in Europe. Because, after all, it is physically a little easier to do it in Europe than to have to come to New York. You cannot now sell anything in the United States, anyway, and even if it was only a small amount on some issues in the past, it was important to them, as far as public issues were concerned—I must make the distinction between public offerings and private placement, because I think it is very important in this whole concept. The tax has certainly made our position much more difficult and our standing in the world capital market far different from what it was a year ago.

Senator BENNETT. This could also be a part of a general weakening of our stature as the leader of the world. This is another little facet in which we have moved back into being one of the group?

Mr. SAMUELS. I shall put it this way, Senator. It adds to a growing belief in some sectors abroad that perhaps the United States is no longer in a position to carry on its world responsibilities in many, many areas, whether they are political, financial, military, whatever they may be, to the extent that we were able to do previously and, therefore, they must look to other arrangements, other formulas, other ways of doing things.

This financial aspect is one—not by itself a decisive one by any means, but one aspect of this whole complex of impressions we leave around the world.

Senator BENNETT. That is the point I wanted to make. That is all. Thank you very much.

That is all I have, Mr. Chairman.

The CHAIRMAN. Senator Dirksen?

Senator DIRKSEN. I have only one question.

Mr. Samuels, do you believe that, in a sense, this forfeits our leadership in the whole financial outlook so far as the world is concerned?

Mr. SAMUELS. It has impaired it very deeply. I shall not say it has forfeited it, Senator, but it has impaired it very deeply. Some of us who are in the investment banking business are of the opinion that there are ways other than H.R. 8000 of meeting the requirements of the U.S. Government and the balance-of-payments problem, which is a very serious problem which we have talked about for a long time.

There are various alternatives—I shall not say many alternatives—but I think there are alternatives that are preferable to this. Some people think one thing, some another; some people think a capital

issues committee would be helpful, whether voluntary or Government operated.

I happen to be one who thinks that a capital issues committee has inherent in it great difficulties. But the IBA has taken no position on these alternatives.

I personally believe that even if you had this tax and you exempted foreign dollar issues up to, say, 20 or 25 percent from taxation, so that you could sell even a modest amount in this country, not all but even a modest amount, and that the tax to be applied beyond this percentage made it reasonably certain that not more than a limited amount of the issue would be sold in this country, we would have accomplished all we are setting out to do with H.R. 8000 without the disadvantages.

We would have kept our market open, the clients would have continued to come back here, we would have absorbed a portion of the issues which even the Treasury, I think, would agree, by and large, is sustainable.

If you assume an annual outflow of about $2 billion, by annualizing the little over $1 billion outflow of the first 6 months of 1963, which may or may not be a valid assumption, and private placements which are sold almost wholly in the United States are largely ruled out by the effect of the tax you would come down to about $500 or $600 million sold in the United States, and that, I believe the Treasury regards would be tolerable. We would have retained our position, met the Treasury's requirements, we would not have borne the onus of having shut down our capital market and would have kept our leadership.

This is what we have always done. We have sold modest proportions in the United States, and only recently they have gone up, by and large, to about 50 percent on public issues. They were often 25 percent or lower. It is the private placement that has affected the outflow and there the tax would have had a beneficial effect; not that there is anything inherently wrong in private placements; I would not say that. But if you want to get at anything in respect to portfolio investment that has really hurt the balance of payments, it is the private placements. This kind of transaction which falls 100 percent on the American balance of payments because you cannot easily divide these; the Europeans do not like that type of issue—they want our public issues, which they buy in great amounts, they are avid to have them. Here I think we have a chance to work out something.

This is a personal view. The IBA has not taken a position on this or any other alternative method, but I am simply outlining what I think might be a constructive approach.

I have discussed this with the Treasury. The Treasury has some objections which I do not think are valid, but that is a matter of a point of view.

I would add one other thing, sir. If you did exempt issues in part, let us say—let us say 25 percent, simply to use an illustration—when sold to an American, the bonds sold to Europeans on original issue would remain taxable when an American bought them, so you would not have a flow-back of these securities to the United States after issue. If you gave the President or the Secretary of the Treasury authority to increase or decrease that exemption percentage, depending

on how the balance of payments was progressing, you would have added a great deal of flexibility to this. And if what I say is true, that the fundamental trends are working in our direction and 6 months from now, the Secretary of the Treasury thinks, "Well, instead of 25 percent, I think I can make this 35 or 40 percent," very well. If we are wrong, he can reduce this percentage exemption on all issues, not selectively. I certainly feel selective controls on issues are probably unwise.

He might say, "Well, things are so bad that I had better eliminate the exemption entirely." But give him some discretion. I think you would have added enormously to the workability and the practicability without all the damage.

Senator DIRKSEN. Has that alternative proposal been drafted?

Mr. SAMUELS. It has been drafted informally in the sense of a memorandum which I did give to the Treasury a few months ago for their consideration, and on which they did make some comments as to why they felt it was not workable from their point of view. As I say, on their stated objections, I disagree.

Senator DIRKSEN. Could it be drafted again?

Mr. SAMUELS. That would be no problem.

Senator DIRKSEN. May I respectfully suggest that you draft it for us?

Mr. SAMUELS. Certainly.

Senator BENNETT. And submit it to this committee?

Mr. SAMUELS. Oh, yes; certainly.

(The material referred to and accompanying letter from Mr. Samuels follows:)

KUHN, LOEB & CO.,
New York, July 2, 1964.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: In accordance with the request made of me yesterday morning by your committee, I am enclosing a memorandum outlining the proposal I made to amend H.R. 8000 to permit a limited portion of new foreign issues to be sold to U.S. persons without being subject to the interest equalization tax.

The purpose of the proposal is to permit the U.S. capital market to function in as normal a manner as possible within the limits determined by the Treasury to be compatible with the U.S. balance-of-payments position at any given time. I believe that an exemption of, for example, 25 percent of the amount of any new foreign issue, coupled with authority of the Secretary of the Treasury to raise or lower this percentage from time to time, would achieve this objective.

I had suggested 25 percent as the initial exempted percentage because I believe that figure to be readily sustainable by our current balance-of-payments position and one which will permit, at least to some extent, a continuation of the pattern of foreign dollar public offerings which were made through our capital market prior to July 1963. (As I mentioned in my testimony yesterday, very substantial portions of such public offerings were placed with investors outside the United States.) However, I would hope that, as and if the balance-of-payments outlook continues to improve, the 25-percent exemption would be increased, perhaps substantially, in the near future.

I am at your disposition to provide any further information or explanations which might be of use to your committee.

Very truly yours,

NATHANIEL SAMUELS.

MEMORANDUM FROM NATHANIEL SAMUELS

The proposal is as follows:

1. Any debt or equity issue by a foreign issuer or obligor acquired by an underwriter would be exempt from the interest equalization tax if not more than 25 percent of the principal amount of debt obligations or of the shares of stock of the aggregate issue is sold to U.S. persons. The Secretary of the Treasury would have the authority, in his discretion, to increase or decrease the specified percentage applicable to all issues from time to time, in accordance with the Treasury's view of the U.S. balance-of-payments position. If an amount in excess of the specified percentage is sold to U.S. persons, this provision could nevertheless be availed of by payment of a tax on such excess equal to 150 percent of the tax normally payable on the amount of such excess.

2. The proposed exemption would be in addition to the other exemptions contained in H.R. 8000 (or in the amendments recently recommended by the Treasury) and would not affect, for example, the exclusion for investments in less developed countries.

3. In order to avoid a possible flowback to the United States of securities sold to foreigners, the exemption would apply only to the initial distribution or placement and not to the security itself; i.e., a subsequent resale to a U.S. person by a foreign purchaser would be subject to the tax.

4. Policing of the proposed exemption would not be administratively complex from the Treasury's point of view since under the proposal the Treasury would utilize the mechanics of a certification similar to that now provided for in H.R. 8000. In effect, the managing underwriter would be responsible for furnishing to the Treasury a certificate, based on certificates of the participating underwriters and dealers, as to the distribution of the securities to United States and foreign persons.

(The amendments to H.R. 8000 (as passed by the House of Representatives) covering the foregoing proposal are attached hereto.)

SUGGESTED AMENDMENTS OF H.R. 8000

1. Add as a new paragraph (4) to section 4919(a) the following:

"(4) CERTAIN OTHER TRANSACTIONS.—Are acquired by an underwriter in connection with a public offering or private placement by a foreign issuer or obligor provided that not more than 25 percent of the total number of shares of stock or total principal amount of debt obligations sold are sold (including sales by others) to U.S. persons. The Secretary or his delegate may from time to time by regulation increase or decrease such percentage that may be sold to U.S. persons, provided that any decrease in the percentage theretofore in effect shall not be effective until 60 days after notice of such decrease is published in the Federal Register. If more than the prescribed percentage then in effect is sold to U.S. persons the provisions of this paragraph (4) shall nevertheless be satisfied if a tax equal to 150 percent of the tax imposed by section 4911 is paid on the amount of sales to U.S. persons in excess of such prescribed percentage. Any tax so paid shall be deemed to be a tax paid under section 4911."

2. At the end of the second sentence of section 4919(b), page 51, line 24, add the following: "or the provisions of paragraph (4) of section 4919(a) have been satisfied."

3. In the third sentence of section 4919(b) following the words "foreign persons" on page 51, line 25, add: "or as to the satisfaction of the provisions of paragraph (4) of section 4919(a)", and following the word "person" on page 52, line 6, add: "or the provisions of paragraph (4) of section 4919(a) were satisfied".

4. In the fourth sentence of section 4919(b) following the words "foreign persons" on page 52, line 12, add: "or as to the satisfaction of the provisions of paragraph (4) of section 4919(a)".

Senator BENNETT. Is that what you referred to when you say:

> If the Executive and the Congress were to deem it essential to take action in lieu of H.R. 8000, we believe that measures can be devised which may be more flexible, appropriate and less harmful.

Mr. SAMUELS. Yes, sir.

The CHAIRMAN. Thank you very much, Mr. Samuels.

Mr. Michael Waris, Jr., of Baker, McKenzie & Hightower.

STATEMENT OF MICHAEL WARIS, JR., OF BAKER, McKENZIE & HIGHTOWER, ACCOMPANIED BY ALAN MARCHMENT, PRESIDENT, TRANSAMERICA INTERNATIONAL S.A., AND ROBERT EINZIG, CONSULTING ECONOMIST

Mr. WARIS. Mr. Chairman and members of the committee, my name is Michael Waris, Jr. I am a partner in the Washington office of the Chicago-based law firm of Baker, McKenzie & Hightower. To my right is Mr. Alan R. Marchment. He is the president of Transamerica International S.A. He heads up the European operations of Transamerica and has come over from Paris to be of assistance during the course of this hearing.

To my left is Dr. Robert S. Einzig, who is a consulting economist for Transamerica Corp.

Our purpose here today is to discuss with this committee one provision in the bill. This is section 4915 which exempts from the tax any investment in a foreign corporation where the investor owns 10 percent or more of the corporation's voting stock.

Transamerica, a U.S. company, owns 51 percent of the stock in a foreign corporation, but it will not get the advantage of this exemption from tax because the foreign corporation is a bank. Under the technical wording of the bill any foreign corporation which is formed or availed of to acquire foreign debt obligations—one of the normal functions of a bank—does not qualify for the exemption. However, there is one group of banks which is not affected by this formed or availed of test. The bill expressly provides that a direct investment in a foreign "commercial" bank will not be subject to the tax.

We can see no justification for restricting this exemption solely to commercial banks. Commercial banks have been given this exemption because of the role they play in financing the export of U.S. goods to foreign countries. This exemption applies even though the bulk of this financing is done with U.S. dollars. Also, to the extent these banks operate through foreign branches they receive deposits in foreign moneys and make loans in foreign moneys. Since this branch activity has little or no adverse effect on the U.S. balance of payments, further justification is found for exempting commercial banks.

We wish to emphasize here today, that our French bank, which I shall hereinafter refer to as CEB, will be doing the same things which have justified the exemption for commercial banks, but with substantially less drain on U.S. dollars. However, because the deposits CEB receives are for a longer term than the terms of deposits received by commercial banks, and because its loans are generally for longer periods, it may not meet the technical definition of a commercial bank in the United States. Therefore, we ask this committee to make it clear that under the bill CEB will receive the same treatment as that extended to commercial banks.

Although the foregoing points up the equities in our position there is a consideration of overriding importance as far as improving the balance-of-payments position of the United States is concerned. If the U.S. shareholders of CEB are required to pay the 15-percent penalty tax the growth of a new European capital market will be severely retarded.

34-937—64——14

As you will recall, just this Monday, when Secretary Dillon testified before this committee, he stressed the need for the development of European capital markets as the real solution to the excessive demands on U.S. lenders. In his original balance-of-payments message in 1963 President Kennedy urged

> A broad and intensive effort by the U.S. financial community * * * to increase the availability of foreign financing for U.S. business operating abroad.

On May 21 of this year, in Vienna, Austria, Secretary Dillon said:

> U.S. portfolio capital in large amounts should not be asked to support the expansion of developed areas with strong balance-of-payments positions. Increasingly flexible and efficient capital markets in Europe—capable of supplying funds at reasonable rates of interest—will remove one major source of difficulty.
>
> * * * * * * *
>
> During recent years, Europe has taken significant steps toward improving her capital markets. The increasing economic integration of Europe offers an opportunity for much greater progress in the future, and it is imperative that the opportunity be seized.

We agree wholeheartedly with these statements of President Kennedy and Secretary Dillon. It is imperative that the opportunity for participating in the development of European capital markets by the American financial community be seized without delay.

Our bank, CEB, is already playing an important role in introducing increased flexibility and efficiency into the money markets of Europe. Moreover, the contribution of CEB cannot be measured in terms solely of the foreign lending power which it itself is generating. CEB is in the nature of a pilot project which is being watched with great interest by other European lenders and bankers.

It can reasonably be anticipated that the success of CEB will trigger the creation of similar enterprises, the cumulative effect of which will be to supply much of the foreign borrowing power, the absence of which is so lamented by the Treasury. Certainly the new 15-percent tax should not impede such a development.

LEVERAGE ON INVESTED CAPITAL

Let me demonstrate to what extent CEB will operate on foreign borrowings. In its first 6 months of actual lending operations, CEB has extended loans of an amount equal to its equity capital ($2,500,000, one-third of which originated in France with its French shareholders). Since that time, CEB has made additional commitments of approximately $1 million. By the yearend CEB will have borrowed in France 3 times its equity capital and will have increased its borrowings to at least 10 times such equity by the fall or yearend of 1965.

All such borrowed funds will be obtained in France from its presently committed sources. None of this money will come from the United States. This means that for every U.S. dollar of equity capital invested in CEB (as well as every dollar invested by the non-U.S. shareholders) at least $10 of French borrowed capital will be raised for lending purposes by the end of 1965. The effect of this process on reducing the demands for borrowing from U.S. sources is thus direct and dramatic.

CEB is effecting its borrowing of French money through the following four means:

(1) Through French bank lines of credit;

(2) Through the receipt of deposits from Frenchmen;
(3) Through longer term borrowing, including debt financing; and
(4) Through the development of new sources of long-term funds such as special arrangements with French life insurance companies.

We submit that enough has been said to demonstrate that CEB is the type of development which should be encouraged rather than hindered and that the new 15 percent tax should not apply to it. However, a number of additional compelling reasons lead to the same conclusion and we would like to mention them very briefly.

SPECIAL BANK INFORMATION RETURNS PROTECT TREASURY

As Secretary Dillon mentioned on Monday, at the request of the Treasury, the House bill contains a requirement on the part of commercial banks to file special information returns so that Treasury can keep track of their future activities. In this way, it can be immediately determined whether such banks are being used to circumvent the bill. Armed with this device, we ask, why does Treasury need to subject a minor portion of the banking community to the rigors of this new tax while the large remainder of the banks goes scot free?

We submit that all banks should stand or fall together—and the new information return is the fair way to determine how they should all be treated.

BASIC COMMITTEE REPORT RATIONALE

The House committee report makes a very logical point in declaring that the various exceptions in the House bill, including the commercial bank exception, all contain a common denominator. It states:

> In general, these exemptions have one factor in common * * * the acquisition of the foreign securities is due to factors other than the interest rate differential between American and foreign securities markets.

On Monday Secretary Dillon indicated that the Treasury itself recommends additional exemptions to the bill based on this precise rationale. Is it not crystal clear that CEB will acquire foreign debt obligations for precisely the same reasons as they are normally acquired by commercial banks—i.e., as an active part of their trades or businesses?

CEB will not be acquiring long-term portfolio investments in foreign securities (the avowed evil against which the bill is directed). CEB will not be acquiring the foreign securities because of the interest rate differential between American and foreign security markets. CEB will simply be engaged in an active trade and business and the rationale for the other exemptions from the tax warrant extending an exemption to this bank.

CEB IS ALREADY BEGINNING TO INCREASE THE PROFITABILITY OF U.S. ENTERPRISE ABROAD

Our final reason is that CEB is already beginning to increase the profitability of U.S. enterprises abroad.

It should be recognized that the profitability of U.S. ventures abroad is enhanced by CEB operations. CEB is already financing U.S. construction firms in France through real estate loans and financing the sale of machinery and equipment made by U.S. manufacturers.

The increase in profitability of our firms operating abroad is of direct assistance to our balance of payments as these profits are remitted to the United States or of indirect assistance when used for reinvestment overseas in lieu of additional dollars from the parent company.

I ask leave of the committee to file a detailed statement supplementing this shorter oral testimony.

The CHAIRMAN. Without objection, it will be included in the record.

(The supplemental statement by Mr. Waris follows:)

STATEMENT TO SUPPLEMENT TESTIMONY SUBMITTED ON BEHALF OF TRANSAMERICA CORP. BY MICHAEL WARIS, JR., OF BAKER, MCKENZIE & HIGHTOWER

We have one very specific objection to the House bill.

In one sense our objection is technical and rather narrow in scope: in another sense it is most fundamental—pointing up the anomalous fact that if the bill is enacted in its present form it will have the effect of substantially retarding the growth of a new source of foreign capital (a French bank). As the administration forcefully maintains, the lack of such foreign capital markets is one of the basic causes of the unfavorable balance-of-payments situation. Further, it is the creation and development of such foreign capital markets which the administration and the Treasury urge the American financial community to foster. This position of the Government is quite sound because, obviously, the more and better these foreign sources of capital become, the less will be the demands of foreign borrowers for U.S. dollars.

FACTS

Perhaps the best way to present our problem is to first describe to this committee in some detail the nature of our foreign business enterprise and the effect which the new 15-percent penalty tax will have upon our efforts to get this venture off the ground.

After spending several years and a considerable sum of money in the intensive study of the feasibility of the venture, Transamerica, in conjunction with a number of other Americans and with French banks formed in May 1963 a French bank, known as Compagnie Europeene de Banque Pour Le Credit a Long et Moyen Terme. Hereafter this French bank will be referred to as CEB U.S. persons own 66 percent of the stock of CEB. In addition to a nominal contribution upon the formation of CEB, a contribution of $1.5 million was made to its capital by U.S. persons in 1963, after July 18, 1963 (the effective date of H.R. 8000). Under subsection (c)(2)(C) of section 2 of the bill, this amount will not be subject to tax because prior to that date the Government of France had authorized the acquisition and approved the amount thereof, as required by French law. This initial capital contribution is exempt from the tax under the House bill because it is in the nature of a commitment made prior to the announcement of the administration's proposal for this new tax.

However, as will be more fully discussed subsequently, there is a distinct possibility that all future contributions to the capital of CEB by U.S. persons will be subject to tax because CEB does not meet the definition of a "commercial bank." Our purpose here today is to urge this committee to modify the bill so as to insure that the same treatment is given to an acquisition by U.S. persons of an equity interest in this new banking venture as is provided for an acquisition in a French commercial bank.

CEB'S POSITION IN THE FRENCH BANKING COMMUNITY

CEB falls under one of the three classifications of banks in France, that of a medium and long term bank. At present, of the approximately 340 banks in France, 20 fall into this classification. The distinguishing feature of this group is that they may not take deposits for a term less than 2 years and must confine their lending operations principally to the 2 to 10 year period. CEB is unique among these banks in that it is the only foreign controlled medium and long term bank (66 percent American owned) and is the only bank engaged in both real estate, and machinery, and equipment financing.

CEB is subject to the regulations of, and to supervision by, the French Commission of Control for Banks. Thus, for example, CEB is required to make

regular reports to the Commission, and its affairs are subject to audit by the Commission. Attached hereto as exhibit 1 is a series of quotations of pertinent portions of the French banking laws. Attached as exhibit 2 is a summary of the overall banking system of France. Among other things, these exhibits show that CEB is classified as a commercial bank under the French banking laws. They also show that to qualify as a bank an enterprise must make a "habitual profession of receiving funds from the public, in the form of deposits or otherwise, funds which they apply for their own financial operations." Clearly then, in view of these provisions of the French laws, the fact that CEB is recognized as a bank shows that it is not a mere vehicle for passive investment in securities but is an active banking business.

French commercial banks fall into three categories: deposit banks, investment banks, medium and long term banks. Deposit banks receive demand deposits or deposits of a term which cannot be greater than 2 years. The principal activity of investment banks is the taking and management of equity participations in existing businesses and making loans in connection therewith. The principal activity of medium and long term banks consists of making loans of which the term is at least 2 years and receiving deposits for a term of at least 2 years. Deposit banks and medium and long term banks are distinguished from investment banks by the fact that their loans are made without normally taking equity participations. Medium and long term banks and deposit banks are treated identically under the French banking regulations with respect to any equity participations they may wish to take, since this is not to be their normal practice in business.

THE BANK OF FRANCE ENCOURAGED THE CREATION OF CEB

The Bank of France encouraged the creation of CEB for several reasons. First, there is a great need in France for financing of projects which will extend over a 2 to 10 year period. This need is not being adequately met in France, particularly in the provinces, because of the degree of specialized banking knowledge required in making medium and long-term loans. Each type of lending requires a specialized type of knowledge. The technique of making small loans, for example, differs from that of financing automobiles for dealers. Similarly, the technique of extending medium and long-term loans on equipment and real estate differs from both of the former, although all types have certain elements in common. It would be hazardous for anyone to engage in a type of lending other than one in which he has had substantial experience. Because there are few banks serving medium and long term borrowing needs there are relatively few people anywhere who are experienced in this type of lending.

The French provincial banks are completely unequipped to provide this medium and long-term loan service. Several of the provincial banks have become shareholders in CEB. These provincial partners, strategically distributed throughout France, will now be able to extend, either through an experienced representative of CEB located in their local bank, or by direct referral to CEB's Paris office, the specialized services needed by their customers.

In addition, it is expected that new techniques will be developed and be introduced from time to time by CEB which will facilitate borrowing by customers.

Since CEB could provide an answer to these important borrowing needs, it received the approval of the Bank of France.

LEVERAGE ON INVESTED CAPITAL

Before committing themselves to the venture the organizers of CEB ascertained that a ratio of borrowed funds to equity funds of 10 to 1, or greater for this type of bank, could be obtained. It was further determined that a profitable operation could be had if an 8-to-1 ratio was achieved.

In its first 6 months of actual lending operations, CEB has extended loans of an amount equal to its capital equity and has made additional committments of approximately $1 million. By the year end CEB will have borrowed three times its capital equity and will have increased its borrowings to at least 10 times its capital equity by the fall or year end of 1965. All such borrowed funds will be obtained in France from its presently committed sources. This means that for every U.S. dollar of equity capital invested in CEB (as well as every dollar invested by the non-U.S. shareholders) at least $10 of French borrowed capital will be raised for lending purposes by the end of 1965. The effect of this process on reducing the demands for borrowing from U.S. sources is thus direct and dramatic.

It should be emphasized that it is the intention of Transamerica to have CEB stand on its own as an independent organization. Incidentally, it should also be noted that this plan coincides with the thinking of the French Government because at this time, as part of its anti-inflation program, France is particularly discouraging all borrowings abroad. It is the intention of CEB to develop a debt structure similar to that with which its American shareholders are familiar in their U.S. banking operations. This plan is four-pronged; it involves borrowing (1) through lines of credit from other banks, (2) through the receipt of deposits, (3) through longer term borrowing, including debt financing, and (4) through the development of new sources of long-term funds such as special arrangements with French life insurance companies. Let us take a brief look at what CEB has already accomplished and what has been planned for the future with respect to each of these types of borrowing.

Lines of credit

CEB's first step in borrowing of foreign funds was to obtain lines of bank credit which could be used for financing machinery, equipment, and real estate. The Government of France is the biggest lender in France. All banks apply for lines of credit from the Bank of France or one of its agencies, such as Crédit Foncier or Crédit National, which if received can be used for financing projects that the Government encourages. Lines of credit obtained from the Bank of France or one of its agencies are rediscountable lines. In other words, banks may deposit their customers' notes with the Bank of France and receive funds in return at the official Bank of France rediscount rate. Only notes which finance projects approved by the Government, and which meet certain other conditions, qualify for rediscount privileges.

As a step against inflation the Government of France has curtailed bank lending since last year. Bank loan growth cannot exceed a 10 percent annual rate. Rediscount privileges have been curtailed.

Despite these conditions, however, CEB at its inception was given a rediscount line by Crédit National nearly equivalent to CEB's own capital resources and Crédit Foncier agreed to accept paper for rediscount without any limitation. To date, CEB is the only bank in France without any credit restrictions. This is a clear indication of the value placed by the French Government upon the service which CEB is providing. It also indicates what a wonderful opportunity CEB has at the present time for making a real impact on the French banking scene.

Since many projects for financing do not qualify for rediscount privileges by the Bank of France, CEB had to acquire additional lines of credit to support the financing of such nonrediscountable projects. To obtain these funds, CEB requested 5-year lines of credit from some of the commercial banks of France. Loans by these banks to medium- and long-term banks are treated as interbank loans under the laws of France and, as such, are excluded from the present governmental restrictions on bank lending. CEB has been successful in obtaining such lines of credit from two of the largest nationalized commercial banks of France as well as from several private banks. The granting of similar arrangements has been indicated by another nationalized bank. This is not a normal practice for the nationalized banks. Here again, CEB has received special consideration because of its type of operation. The lines of bank credit which CEB has obtained from these French commercial banks is essentially similar to the lines of credit it would obtain from other banks if it were operating in the United States.

In addition to obtaining funds through the various lines of credit just described, CEB has made most of its loans jointly with other banks. This has not only enabled it to finance a greater number of projects throughout France, but has also made it possible to finance larger projects than it otherwise could have financed in relation to its capital resources. CEB thus acts as a vehicle for financing the needs of these banks' customers which these banks are not either well equipped or are unable to handle. This is certainly true with respect to customers of U.S. banks desiring medium- and long-term financing of their equipment purchases or plant additions. In such cases it is unnecessary to resort to loans from U.S. banks or from their U.S. parents.

In addition to this provision of French francs borrowed from Frenchmen to avoid further drains of dollars for U.S. subsidiaries in France, it should also be recognized that the profitability of U.S. ventures abroad is enhanced by CEB operations. CEB is already financing U.S. construction firms in France through real estate loans and financing the sale of products made by U.S. subsidiaries

through home repair and modernization loans. The increase in profitability of our firms operating abroad is of direct assistance to our balance of payments as these profits are remitted to the United States or of indirect assistance when used for reinvestment overseas in lieu of additional dollars from the parent company.

The fact that CEB will lend francs generated in a ratio of 10 to 1 to dollars cannot be overemphasized. These loans, in addition to contributing to a lessened need for dollars by U.S. subsidiary firms, will also reduce the dependence of the French economy on short-term financing of long-term projects. To the extent that this technique is employed in France it helps to improve the quality of the French capital market and reduces the likelihood of borrowings at long term directly from the United States. It is indeed an anomaly that commercial banks in the United States are excluded from the tax. They lend U.S. dollars to the full extent of their operation for short term only and thereby contribute little to the development of long-term capital markets. CEB, a medium- to long-term lender, which is assisting in the development of an independent capital market in France and lends mainly foreign funds, is possibly subject to the tax.

Deposits

One of CEB's normal activities will be to receive deposits. As above described, under French law CEB will be restricted to the receipt of deposits of at least 2 years in length. However, these deposits will be in foreign currencies and will constitute an important source of CEB's borrowed funds. The amount of deposits thus far received by CEB has not been very significant because it has not been in operation long enough to be legally able to receive deposits. This it could do only after it had published its first balance sheet. Such publication occurred in the latter part of May 1964.

Much of the personal wealth of France is held in the provinces. CEB hopes to attract a good portion of these funds in the form of deposits through its provincial banking partners. Obviously these deposits will be in French francs which, in turn, will be a source of funds for CEB to lend.

Long-term funds and debenture financing

In connection with its lending operations over 5 years, especially in the field of real estate, arrangements have been made with a crédit différé organization. A crédit différé company is one which grants loans contingent upon the deposit by the borrower of several installment payments preliminary to the disbursement of the loan funds, which are made after a waiting period. Normally such a company would be of little use to a borrower who wishes to purchase a home today, and does not wish to have to accumulate savings in an account for the first 5 years of a 10-year period. In practice, an intermediary, such as CEB is used to act on behalf of the borrower, advancing the total necessary funds for the purchase today. The borrower is then given a normal regular payment schedule for the period which he can follow. The arrangement made between the financial intermediary, in this case CEB, and the crédit différé organization (with whom CEB is acting jointly) is that CEB's advance remains unamortized during the first half of the term of the contract, at which time the principal advance by CEB is paid off by the crédit différé organization, the remaining balance of the loan being assumed by the latter. In France there are only two crédit différé organizations, both of which were formed by banking groups.

In the long run, of course, it is expected that long-term funds will be obtained on a basis comparable to that in the United States which can be used not only for real estate purposes which crédit différé organizations satisfy but also for machinery and equipment financing.

As another step in CEB's planned debt structure, Transamerica has taken steps to establish the feasibility of raising such long-term funds through debenture financing. In the area of debt financing the European financial maket leaves much to be desired. There is neither the sophistication as to type of debt nor the distribution facilities for placing issues, such as exist in the United States. It is the lack of this type of capital market which has been consistently so much lamented by the administration. As a matter of fact Secretary Dillon stressed this point repeatedly when he testified before this committee on Monday, June 29. His views are fully supported by the most recent annual report of the Bank for International Settlements—which Mr. Dillon cited with approval. It is this very deficiency of the foreign capital markets which Transamerica is taking specific steps to remedy.

It appears feasible to Transamerica to issue not only senior debt but also something other than senior debt at a reasonable rate, and for a reasonable return. To solve the problem of distribution, Transamerica is considering the possiblity of using CEB's French provincial "branch" system to reach investors not normally contacted. Moreover, it is felt by Transamerica that this area of debt financing would be a far easier one to develop if it had similar financial operations in more than one country. Such an arrangement would provide far greater flexibility not only in raising funds in the currency of the country in which an operation existed, but it would also facilitate borrowing other European funds held in those countries for use in the country of origin.

With respect to this proposed debenture financing Transamerica has talked to principal underwriters, investment bankers and others in France, Switzerland, and Luxembourg and has been assured that what Transamerica would like to accomplish is definitely possible. The first objective would probably be to borrow on a 15-year subordinated debt issue. Though this type of debt does not appear to have been used in Europe, the underwriters contacted thought that it would prove workable. As previously mentioned, to facilitate distribution, the provincial bank network will be of real assistance.

Development of new sources of long-term funds

Transamerica has already fostered innovations which are helping to overcome the inflexibility of European lending practices. At present, for example, long-term money for real estate financing cannot be obtained by banks or other companies from life insurance companies. To overcome this restrictive practice, CEB has made an arrangement with one of the major French life insurance companies, which frees funds for the borrower by having CEB act, in effect, as an intermediary making the loan to the borrower for the account of the life insurance company while retaining the management of the account on behalf of the life insurance company. This is the first time such an arrangement has been effected by anyone. Similar arrangements will be made with other major French life insurance companies in the near future.

Transamerica is convinced that the financial services which it provides in foreign countries contributes much to their economic well-being. It is thoroughly convinced, also, that banks such as CEB established in foreign countries can raise adequate foreign borrowed funds to support their operations.

ADMINISTRATION STRESSES NEED TO DEVELOP FOREIGN CAPITAL MARKETS—CEB IS DOING JUST THAT

On July 18, 1963, President Kennedy sent a special message to Congress on the balance of payments. To improve the balance-of-payments picture the President stressed that a direct action program was needed "to increase foreign participation in the financing of new or expanded operations on the part of U.S. companies operating abroad." Specifically, the President urged:

"A broad and intensive effort by the U.S. financial community to market securities of U.S. private companies to foreign investors, *and to increase the availability of foreign financing for U.S. business operating abroad*." [Emphasis added.]

CEB fits squarely into the design recommended by President Kennedy. It is doing precisely what he so forcefully pointed out as being so essential to improving our balance of payments. It is causing foreigners to join in partnership with U.S. interests in the vital area of utilizing foreign financial resources rather than coming to the United States for required financing.

Secretary of the Treasury Dillon has consistently and frequently repeated and expanded upon the foregoing theme of President Kennedy. Thus, on August 20, 1963, in testifying before the House Ways and Means Committee Mr. Dillon said:

"Today, a disproportionate share of the demands for capital from all the world—from deficit and surplus countries alike—converges on the United States * * *. A substantial portion of these rising demands must be diverted to markets in other nations, particularly those now in a strong external position, if the stability of the international financial system as a whole is to be protected." The Secretary further stated that the need for the new tax which is merely a transitional means for improving the balance-of-payments picture, will end as longer range measures "to build more effective capital markets abroad become more effective."

As recently as May 21, 1964, at the 11th International Monetary Conference of the American Bankers Association in Vienna, Austria, Secretary Dillon forcefully reiterated the need for improved foreign sources of borrowing as follows:

"U.S. portfolio capital in large amounts should not be asked to support the expansion of developed areas with strong balance-of-payments positions. Increasingly flexible and efficient capital markets in Europe—capable of supplying funds at reasonable rates of interest—will remove one major source of difficulty."

We agree with this statement wholeheartedly and submit that CEB is already playing an important role in introducing increased flexibility and efficiency in money markets of a developed industrial country, France. Moreover, the contribution of CEB cannot be measured in terms solely of the foreign lending power which it itself is generating. It must be remembered that CEB is in the nature of a pilot project which is being watched with great interest by other European lenders and bankers. It can reasonably be anticipated that the success of CEB will trigger the creation of similar enterprises, the cumulative effect of which will be to develop the foreign long-run borrowing facilities, the absence of which is so lamented by Secretary Dillon.

Secretary Dillon also said:

"During recent years, Europe has taken significant steps toward improving her capital markets. The increasing economic integration of Europe offers an opportunity for much greater progress in the future, *and it is imperative that the opportunity be seized*. Recent experimentation in achieving a broad European market for security flotations deserves to be carried further despite the difficulties that have been encountered. The increase in dollar-denominated loans under the stimulus of the proposal for the interest equalization tax, the use of unit of account loans, and the proposal by Hermann Abs for separate national shares in large European flotations, are all developments of considerable significance." [Emphasis added.]

Here again we agree with Secretary Dillon. We fully agree that it is imperative that the opportunity now presented for participating in the development of European capital markets by American interests be seized without delay. We feel that CEB is a golden opportunity which is already proving its effectiveness and which should not be retarded by this new tax. Certainly, in view of the Treasury's advocacy that these capital markets have flexibility and be broadly based, they should not be restricted merely to stock exchanges or the flotation of securities. Any form of enterprise which supplies funds at reasonable rates of interest—foreign funds which eliminate the demands for the borrowing of U.S. dollars—should be encouraged.

DIRECT INVESTMENT EXCLUSION SHOULD BE BROADENED TO COVER CEB

Despite the foregoing, H.R. 8000 in its present form may impose a 15-percent tax on any further contributions to the capital of CEB by its U.S. shareholders. This is such a severe penalty that CEB may have to mark time delaying any further equity expansion of its activities until the tax is removed or expires. This does not make sense, particularly in view of the direct investment exclusion of section 4915, which makes the tax inapplicable to acquisitions of 10 percent or more of the voting stock of a foreign corporation. No inquiry is made under this section into the effect this exclusion may have on the balance of payments. No limitations are set on the amount of equity capital which may be funneled out of the United States under its aegis. It is obvious that the immediate adverse effect on our balance of payments under this exemption could be tremendous. Presumably, then, all export of U.S. capital is not per se bad. Some of this exporting process must be considered as beneficial. What then is the justification for section 4915 and why doesn't CEB receive its benefits?

The explanation is given in the House committee report that the exemption of section 4915 comes into play where a substantial voice in the management of the foreign entity is acquired by the U.S. person. The exemption is premised on the theory that decisions to make investments involving active participation in management are largely concerned with questions of market position and long-range profitability rather than interest rate differentials. Therefore, it was felt that application of the new tax, which is intended to equalize the costs as between capital markets, would not be appropriate in this area. Doesn't this reasoning apply squarely to CEB?

The "direct investment" exception does not apply if the foreign corporation or partnership is formed or availed of by a U.S. person for the principal purpose of acquiring stock or debt obligations of foreign issuers which would have been

subject to tax if the U.S. person had made the acquisition directly. However, the House bill provides that the "formed or availed of" test does not become operative with respect to a foreign corporation which acquires stock or debt obligations in making loans in the ordinary course of its business as a "commercial bank."

It is the narrowness of this latter rule that causes CEB's problem. It is this exemption that we ask this committee to expand. Why should business loans be permitted to be made to foreigners only through the medium of a foreign "commercial" bank? Certainly the activities of CEB should qualify it as not having been formed or availed of to circumvent the tax.

The acquisition of a stock interest in CEB or any other active bank or finance company (regardless of whether it qualifies as a commercial bank) is no different from any other direct investment acquisition which, under section 4915, is exempt from the tax if a 10-percent or greater stock interest is acquired. The mere fact that the business involved is a banking business (as distinguished from a "commercial" banking business or some other type of business) should not cause it to be taxed. On the contrary, we feel that a good case has been presented justifying that CEB be given better treatment than the ordinary commercial venture. The contribution of CEB toward improving foreign capital markets deserves encouragement rather than hindrance.

It is obvious that the formed or availed of test should apply only where the foreign corporation is being acquired as a device or subterfuge for circumventing the interest equalization tax. If an actual bona fide banking or financing business is going to be conducted, then, certainly, the interest equalization tax should not apply.

The committee report lends firm support to this point of view. In describing the purpose of the "formed or availed of" test it states that "U.S. persons will not be allowed to form 'closely held' holding companies for the purpose of acquiring securities which would be taxed if acquired directly." The creation of an active bank such as CEB is certainly unlike the formation of a closely held holding company. Manifestly, the formed or availed of test should be applied only to the types of situations referred to in the committee report.

While the House committee report is silent as to why foreign "commercial" banks alone were singled out for favorable treatment under section 4915, presumably the same reasons apply as were given for the exemption provided to domestic commercial banks in section 4914(b) for acquisitions of foreign debt obligations made in the ordinary course of their commercial banking businesses.

The basic justification of the Ways and Means Committee for this "commercial" bank exemption is that "it recognizes the special role played by banks in support of normal, recurring financing of the international business of American firms." The committee report further states that the exemption "Also, * * * permits the banks to continue freely their role in financing U.S. exports and their conduct of banking operations in foreign countries through branches. In this latter case, their activities normally consist of receiving deposits in foreign currencies and making loans in such currencies. These transactions, of course, have no effect on the U.S. balance-of-payments position." Does this not describe the operations of CEB? Obviously, there is no real justification for arbitrarily drawing the line at commercial banks. Competing financial institutions such as CEB should be brought within the scope of this exemption.

The significant characteristic CEB has in common with "commercial" banks is that it is engaged in the active conduct of business. Its activity does not in any way represent the mere acquisition of passive investments in the nature of long-term portfolio investments. The statements made by the Secretary of the Treasury in urging the enactment of H.R. 8000 are replete with the assertion that the evil sought to be curtailed by this legislation is the great acceleration in long-term portfolio investments in foreign securities by U.S. persons. It would be most regrettable if in seeking to accomplish this objective, legitimate active banking businesses (an entirely different thing from portfolio investments) should be adversely affected by this new tax. Indeed, in view of the contribution CEB will make toward improving the balance-of-payments situation, the retention of section 4915 in its present form borders on the fantastic.

GENERAL RATIONALE FOR ALL EXEMPTIONS IN H.R. 8000 DICTATES THAT CEB BE EXEMPT

It is most important to observe that the fundamental underlying justification for all of the exemptions and exclusions presently contained in the House bill, including the commercial bank exemption, strongly and fully supports the proposition that the acquisition of CEB should be exempt from the tax. This basic theme for exemption is announced by the Ways and Means Committee as follows:

"Your committee's bill also provides a series of additional exemptions, described below, designed to deal with specific types of situations. Some of these relate to businesses which, because of their nature, deal in foreign securities. Others are related to natural resources or raw material sources outside the United States. The other exemptions are for various other factors. In general, these exemptions have one factor in common, however: *the acquisition of the foreign securities is due to factors other than the interest rate differential between American and foreign security markets.*" [Emphasis added.]

Clearly, the making of loans to foreigners by CEB is not due to the interest rate differential between American and foreign security markets but is attributable to the same business motivation which prompts its U.S. shareholders to make similar loans in the course of their domestic financial operations, i.e., to realize interest income in the course of an active financial business.

In view of the foregoing rationale, so clearly expressed by the Ways and Means Committee, it is difficult to understand why a bank such as CEB is not included within the exemption within question. Possibly at the time H.R. 8000 was reported out by the House Ways and Means Committee the overall concept of the bill had not evolved to the point where this common thread running through the various exemptions stood out with sufficient clarity. However, now that this common denominator has been clearly identified, the "commercial" bank exception clearly should be expanded to include other similar financial institutions such as CEB.

Special information returns to be filed by banks protect Treasury

The only real concern which the Treasury Department should have with respect to banks is that foreign borrowers may artificially change their methods of financing and divert their borrowing activities from normal channels to banks in order to avoid the interest equalization tax. Secretary Dillon expressed this concern at the beginning of the executive sessions before the Ways and Means Committee on October 21, 1963, as follows:

"* * * the possibility of abuse of this [commercial bank] exemption, particularly if potential foreign long-term borrowers attempt to shift their demands to the banks, must be recognized. Therefore it is important that we follow developments in this area closely. Our ability promptly to detect and discourage any such possible abuse would be greatly facilitated by an amendment to H.R. 8000 providing the Treasury with specific authority to obtain from the banks timely reports in adequate detail on the nature of their current foreign lending activity."

In accordance with the Treasury's request, the Ways and Means Committee added a provision to H.R. 8000 requiring all commercial banks to file, in accordance with regulations to be prescribed, information returns with respect to loans and commitments to foreign obligors. It is contemplated that these information returns may include (in addition to any information on aggregate lending activity) information concerning the purpose of each loan, the type of borrower, and the principal terms of the transaction.

It is the view of the Ways and Means Committee, and presumably the Treasury Department, that these returns will produce detailed and timely information on the nature of, and trends in, commercial bank lending to foreign persons. The evidence thus supplied will indicate whether such bank lending to industrialized countries abroad, whose borrowing would otherwise be subject to tax, was rising in amounts related to the normal recurring needs of international trade. The committee report states that a "sizable increase in bank lending that appeared to be related to a diversion of credit demands from channels subject to the tax would be a source of particular concern to your committee."

We submit that the real answer to the Treasury's concern is found in this requirement for the filing of information returns. If banks actually become an avenue through which the new tax is being deliberately circumvented, then appropriate steps can be taken to stop that diversion. However, as long as banks continue to serve the legitimate needs of commerce and industry, as they have in the past, they should not be affected by the new tax.

If any valid distinction existed between "commercial" banks and other banks and financial institutions at the inception of H.R. 8000, it ceased to exist upon the inclusion of this provision for information returns. The real problem is the utilization of any type of bank for the circumvention of the new tax. The new information returns give the Treasury the tools it needs to keep a check on the overall banking picture. With such an equitable mechanism at its disposal, it seems quite arbitrary and unfair to use the meat axe technique adopted in the bill of extending the exemption in question only to "commercial" banks.

Recent legislative precedents support exemption of CEB

Although the contexts are somewhat different, other provisions of the Internal Revenue Code recently adopted by the Congress to restrict certain types of foreign operations illustrate that the undue narrowness of the commercial banking exception represents a departure from the sound congressional policy of noninterference with active trades or businesses.

Section 954(c)(3)(B) was added to the code by the Congress in 1962 for the purpose of exempting from the so-called tax haven legislation income derived in the conduct of a banking, financing, or similar business. The report of the Senate Finance Committee relating to section 954(c)(3)(B) states that the committee saw "no need to maintain the deferral of U.S. tax where the investments are *portfolio* types of investments, or where the company is merely *passively* receiving investment income." [Emphasis added.] However, such deferral was to continue (that is, the tax haven provisions were not to apply) with respect to interest, dividends, etc., when such income "arises in connection with certain actual business activities." Specifically, such activities were "the conduct of a banking, financing, or similar business."

Similarly, H.R. 8000 should exempt securities acquired "in the conduct of a banking, financing, or similar business."

Another congressional enactment in 1962 further supports the proposition that H.R. 8000 should not interfere with the carrying on of an active banking or finance business. Section 10 of the Revenue Act of 1962 modified the operation of the foreign tax credit for the specific purpose of discouraging U.S. persons from making certain short-term investments in Canada which, by earning interest taxed by Canada at a lower rate than other types of Canadian source income, would enable such U.S. persons to get a bigger foreign tax credit on their higher taxed Canadian income. The basic, in fact the only, justification offered for this amendment to the foreign tax credit was the effect on our balance-of-payments position. In other words, the justification for section 10 of the Revenue Act of 1962 and H.R. 8000 are exactly the same.

Therefore it seems pertinent that in enacting said section 10 the Congress wisely excluded active trades and businesses from its impact and expressly excluded interest "derived in the conduct of a banking, financing, or similar business."

Consistency as well as equity and the fundamental objectives of H.R. 8000 would appear to require that a similar exception be included in H.R. 8000.

If, for some reason, the legislative language above suggested is too broad, other acceptable alternatives are as follows:

A new paragraph (4) could be added to section 4915(c) to read as follows:

"(4) DEFINITION OF COMMERCIAL BANK.—For purposes of this subsection, the term 'commercial bank' means any foreign corporation or foreign partnership which—

"(A) is defined to be a commercial bank under the laws of the United States; or

"(B) under the laws of any foreign country or countries is normally engaged in the business of borrowing funds in foreign currencies and making loans in such currencies."

Another acceptable alternative:

"(4) DEFINITION OF COMMERCIAL BANK.—For purposes of this subsection, the term 'commercial bank' means any foreign corporation or foreign partnership which—

"(A) is defined to be a commercial bank under the laws of the United States; or

"(B) under the laws of any foreign country or countries is normally engaged in the business of receiving deposits and other borrowed funds in foreign currencies and making loans in such currencies."

Respectfully submitted.

RUSSELL BAKER.
MICHAEL WARIS, Jr.

EXHIBIT 1

The following quotations are from "Law No. 2532 of the 13th of June 1941 relative to the regulation and organization of the profession of banking and modified by the law of May 24, 1951, article 49."

A. Definition of a bank: Article 1: "Considered as banks are enterprises or establishments which make a habitual profession of receiving from the public, in the form of deposits or otherwise, funds which they employ for their own account, in discount operations, in credit operations or in financial operations. * * *"

B. "List of Bank—Right to the Name of Bank": Article 12: "No enterprise can, without having been previously inscribed on the list of banks, exercise the activity defined in the first article, nor may indicate the term 'bank,' 'banker,' or 'credit establishment' in its name or in its description of its business purposes, or in its advertising, nor make these references in any other manner whatsoever in relation to its activities."

C. "Furnishing of Information to the Commission of Control": Article 17: "Banks must furnish to the commission of control, on its demand, all information, explanations, and proofs, necessary for the exercise of its duties."

D. "Credit organizations":

Article 4 (law of May 17, 1946, article 1): "There are three categories of banks: deposit banks, investment banks, and medium- and long-term banks. * * *"

Article 5 (law of May 17, 1946, article 2): "Deposit banks are those which receive sight deposits or deposits of a term which cannot be greater than 2 years. * * *"

"Investment banks are those whose principal activity is the taking and the management of participations in existing businesses or in the formation and opening of credits without limitation to public or private enterprises, which benefit, have benefited or should benefit from the said participations. * * *"

"Medium- and long-term banks are those whose principal activity consists of opening credits of which the term is at least equal to 2 years. They cannot receive deposits, without the authorization of the Committee for Medium- and Long-Term Credit of the Conseil National du Credit, for a term less than this duration. *They are subjected to the same limitations as the deposit banks concerning their participations.*" [Emphasis added.]

EXHIBIT 2

SUMMARY OF THE FRENCH BANKING SYSTEM

Placed under the authority of the Conseil National du Credit:
- A. Bank of France (the bank of issue).
- B. The commercial banks:
  - Deposit banks.
  - Investment banks.
  - Medium- and long-term banks.

Relating directly to the ministries:
- C. Banking organizations subject to special legal statute:
  - (a) Comparable to banks:
    - Agricultural credit.
    - Credit populaire (small business loans).
    - Cooperative credit (loans to co-op societies).
  - (b) Not receiving deposits from the public:
    - Le Credit Foncier de France.
    - Le Credit National.
    - La Banque Francaise du Commerce Exterieur.
    - La Caisse Nationale des Marches de l'Etat.
  - (c) Not extending credit:
    - Les Comptes Courants Postaux et les Comptables directs du Tresor.
    - Les Caisses de Depots et Consignations et les Caisses d'Epargne (national or private).

In addition there are:
1. For reconstruction and development:
   - La Caisse Autonome de la Reconstruction.
   - Le Fonds de Modernization et d'Equipement.
   - Le Fonds de Developpement Economique et Social.
   - Les Caisses Nationaux de l'Energie.
2. Placed under the authority of the Conseil National du Credit:
   - Financial establishments.
   - Financial intermediaries.

Senator BENNETT. May I ask you one question, Mr. Chairman? I assume, although you do not make it completely clear, that CEB is domiciled in France.

Mr. WARIS. That is correct.

Senator BENNETT. Are there other similar institutions operating abroad that have been set up by other American financial groups, or is this a unique experiment?

Mr. MARCHMENT. It is unique, Mr. Senator.

Mr. WARIS. It is the only one.

Mr. MARCHMENT. This is the first time that a bank of this type has been set up in any country in Europe. This particular one was encouraged by the Bank of France in order to service the need for financing machinery, equipment, plant, et cetera, and they allowed this one bank to have an American ownership dominate so that we could provide the services.

It was also a condition of the Bank of France that we take on many small French provincial bank partners who, through our bank, could extend this type of service throughout France, which they alone had been unable to do.

Senator BENNETT. I have no other questions, Mr. Chairman.

The CHAIRMAN. Senator Dirksen?

Senator DIRKSON. No, thank you.

The CHAIRMAN. Thank you very much, Mr. Waris.

Mr. WARIS. Thank you.

The CHAIRMAN. Our next witness is Mr. Robert A. Gilbert of Investors League.

STATEMENT OF ROBERT A. GILBERT, INVESTORS LEAGUE, INC.

Mr. GILBERT. Gentlemen, my name is Robert A. Gilbert. I am president of Intercontinental Research & Analysis Co., with offices at 19 Rector Street, New York, N.Y., and officer and director of the Investors League, Inc., with offices at 234 Fifth Avenue, New York, N.Y., on whose behalf I am testifying. I am also chairman of the league's international investment division. The Investors League is a nonprofit, nonpartison organization of thousands of individual investors residing in every State of the Union.

The Investors League is opposed to H.R. 8000, which seems to us the worst possible way of solving our balance-of-payment situation. The league does not consider that the proposed amendments are helpful in offsetting the basic damage done by an equalization tax, although they remove some technical errors in the legislation before you.

The balance-of-payment difficulties of our country stem from the gathering economic effects of mounting debts, Government deficits ignored, wages much too high in relation to net productivity, and socialistic national policies with respect to corporate business.

To put a tariff on American individual private investment equalization tax is in effect a tariff, is not going to make the United States more competitive in economics. In fact, it will aggravate our relative uncompetitiveness by depriving Americans of an opportunity to earn profits abroad in any business which they know very well. These opportunities will be handed over to our competitors who will be the ones remitting profits back home.

Let me illustrate this last point.

This latest monthly bulletin of the De Twentsche Bank of Amsterdam is headlined, "Unremitting Foreign Investment Activities." There follows a list of major new foreign investments in Holland in April. These include a plant by Miles & Wornberg of Sweden at Utrecht to make ladies' plastic handbags; a purchase of a Dutch confectionery company at Utrecht by Bassett & Co., Ltd., of England; the incorporation by Petri Camera Co. of Tokyo of an assembling subsidiary at The Hague; the acquisition by Gallaher International of England of a 25-percent interest in Niemeyer N.V. of Groningen, a tea and tobacco company; and the conclusion of a technical agreement between Coleman and Wichita, Kans., and Daalderop, on hot water appliances.

The need for capital in Europe is very great due to the strong efforts being made to raise the standard of living. This need is going to be met from whatever alert investors there are, and it would indeed be foolish to deny Americans a chance to participate in it fully. In view of all we have done since the war to bring this capital market to life amidst great initial confusion, it is simply absurd to be put out of it now. In other words, we are throwing away the fruits of all our efforts to persuade Europe to be really capitalistic.

Americans trying for these opportunities would not seem to be such a risk to our balance of payments if there were a return flow of foreign funds seeking chances for profit in the United States. But there is no such flow of magnitude because we are, alas, committed to take the low, slow road in economics.

The following table should show you a few reasons why the United States looks unattractive to foreign investors. Our gain in industrial production is the lowest of any of the major developed nations listed here, our per capita debt the highest, and as for our wage rates they are, as the saying goes, "out of this world." As long as officials in Washington pursue a socialistic policy likely to aggravate these disparities instead of correcting them, foreign capital is unlikely to take much interest in America.

(The table referred to follows:)

	Gain in industrial production [1] (percent)	Debt		Average hourly wages [3]
		Per capita [2]	Percent of national income	
United States	39	$1,574	68	$2.39
United Kingdom	41	1,492	130	.98
France	111	375	33	.49
West Germany	113	179	16	.88
Belgium	57	443	75	.52
Italy	150	790	34	.40
Netherlands	78	456	45	.55
Canada	58	1,173	76	1.88
Australia	75	335	26	1.30
Japan	298	30	8	.31

[1] Total since 1953.
[2] Most recent comparable figures.
[3] 1962 average for manufacturing; latest comparable figures.

I was one of the first witnesses to testify before the House Ways and Means Committee against the equalization tax. At the time I forecast that this act would have a very detrimental effect upon the business structure of some of our neighbors. Soon thereafter, the Canadian, Italian, and Japanese stock markets started down. In fact, the Canadian market fell so precipitously that wthin a short time of the proposal the Canadians asked for and received exemptions. The Canadian industrial stock average had gone down to 615 from 613 and would not have stopped there without the exemptions.

The Italian and Japanese markets have not been so fortunate. The Italian stock index is still drifting toward new lows. Last week it was down to 5,942, or far below its levels prequalization which were up to 8,740. The recation in Japan has also been sharp. Before equalization, the Tokyo Dow Jones index was around 1,608. It has since gone down to 1,204. Recently, it has tried to rally, but it seemed to get stuck around 1,300.

The infusion of American private capital into Italy was enormously encouraging to their economy, and not very expensive to us. Portfolio investment there was running probably less than $50 million a year. I say probably because the Government has no accurate statistics on portfolio investment abroad by Americans. Last year, the door was slammed on this, and as a result, the withdrawal of foreign moneys in Italy was encouraged. What effect did this maneuver have on us as well as on Italy? This spring, the United States had to lend Italy $600 million to save the lira. So, to keep $50 million of enterprising money in the United States, we paid out $600 million of Government funds.

This brings us to another point. It is maintained the equalization tax is working wonderfully well, as in the first quarter of the

year our gold reserve was increased slightly. But these figures on the balance of payments do not include any allowance for the Italian loan. As I understand it, we raised money in Germany to pay Italy. Part of our debt operations are now foreign, and excluded from the usual preview of financial reports.

It really also should be stated against the claim that the equalization tax is working, that it is the uncertainty of the exact legal form of the tax that is working. No one knows what his liability really is. The proposed spate of amendments show this uncertainty, too. No one knows whether the 15-percent tariff will be effective or not. Once its form is settled, there still may be vast demands on our capital, but we will have set the capital markets of the world a bad example by making the dollar partially inconvertible.

The Investors League believes that if H.R. 8000 is to become law, it should be amended in one important aspect to make it both fairer and effective.

The purpose of the amendment to H.R. 8000 (Interest Equalization Tax Act of 1963), which follows in rough draft, is to enable a U.S. person who has paid, or is liable for the payment of, the excise tax on the acquisition of a debt obligation of a foreign obligor, or stock of a foreign issuer, from a foreign person, to secure a refund or credit for the amount of the tax paid, or liable to be paid, if he sells the debt obligation or stock to a foreign person within certain time limits prescribed below.

The necessity for an equity of such an amendment is dictated by the very reasons for which the bill was originally introduced. The report (No. 1046) submitted by Mr. Mills from the Committee on Ways and Means states that the bill (which amends the Internal Revenue Code of 1954) will "impose a tax on acquisitions of certain foreign securities in order to equalize costs of longer term financing in the United States and in markets abroad" and that "the tax is designed to aid our balance-of-payments position by restraining the heavy and accelerated demand on our capital market from other industrial countries."

It is amply apparent that the sale of securities which have been thus taxed to a foreign person will have the opposite effect from that resulting from their acquisition, so far as the balance of payments is concerned. The enactment of the amendment herein proposed can therefore have no adverse effect on our balance of payments. To the contrary, the amendment, because it provides a refund or credit of the tax paid on acquisition of the securities, might reasonably be supposed to have the effect of encouraging the sales of such securities by U.S. persons to foreign persons.

An amendment to incorporate the refund and credit provision into the proposed bill, might take a form similar to that following:

SEC. 4920. SALES BY UNITED STATES PERSONS TO FOREIGN PERSONS.

(a) CREDIT OR REFUND.—The tax paid under section 4911 on the acquisition of stock or debt obligations of a foreign issuer or obligor shall constitute an overpayment of tax to the extent that such stock or debt obligations, are sold by a United States person to persons other than United States persons within two years after (or, in the case of short sales, within two years before) their acquisition. Under regulations prescribed by the Secretary or his delegate, credit or refund (without interest) shall be allowed or made with respect to such overpayment.

34-937—64——15

(b) EVIDENCE TO SUPPORT CREDIT OR REFUND.—A United States person claiming credit or refund under this section shall file with the return required by section 6011(d) on which credit is claimed, or with the claim for refund, such information as the Secretary or his delegate may by regulations prescribe. Credit or refund shall not be allowed with respect to stock or debt obligations sold by a United States person unless the seller establishes by clear and convincing evidence that such stock or debt obligations were sold to persons other than United States persons.

For purposes of the preceding sentence, a certificate of sales to foreign persons (executed in such a manner by the United States person making such sales, filed in such a manner, and setting forth such information, as the Secretary or his delegate may by regulations prescribe) shall be conclusive proof for purposes of the credit or refund that such sales were made to a person other than a United States person unless the person making such sale has actual knowledge that the certificate is false in any material respect.

Amend "Section 7241, Penalty for fraudulent equalization tax certificates," by the insertion, following the words "described in" (line 10, p. 103) of the words, "sections 4919(b) and 4920(b),".

Amend "Section 4920, Definitions" (line 1, p. 85), by the redesignation of this section as "Section 4921."

You will note that time limit has been written into the amendment concerning the sale of the securities. The limit has been selected arbitrarily. Some other limit could be established, but failure to establish any limit at all, would pose an impossible burden in administering the law. Consider, for example, the purchase by a U.S. person of securities subject to the tax, who holds on to the securities for, say, a 15-year period.

Amendment might well also include a provision for the definition of "sales" much as section 4912 defines "acquisition," and certain sales should probably be specifically exempt from the application of the above amendment, e.g., the term "sale" should not include a transfer between a person and his nominee, custodian, or agent.

I thank you, gentlemen.

The CHAIRMAN. Thank you.

Senator Bennett?

Senator BENNETT. I have no questions, Mr. Chairman.

The CHAIRMAN. You give the per capita debt of this country as $1,574. Does that include all debt?

Mr. GILBERT. No, sir, that is the Federal debt.

The CHAIRMAN. That does not include the States?

Mr. GILBERT. No, just the U.S. Government, so it would be even higher with all that other counted in.

The CHAIRMAN. When you say the gain in industrial production is 39 percent, in what period is that?

Mr. GILBERT. Since 1953.

The CHAIRMAN. Are there any questions?

Senator DIRKSEN. I have no questions.

The CHAIRMAN. Thank you very much, sir.

The next witness is Mr. Herbert Gareiss, of Carl Marks & Co., Inc.

STATEMENT OF HERBERT GAREISS, EXECUTIVE DIRECTOR, CARL MARKS & CO., INC.; ACCOMPANIED BY DR. FORCADE, INTERNATIONAL LEGAL ADVISER

Mr. GAREISS. Mr. Chairman and members of the committee, my name is Herbert Gareiss. For some 30 years I have been associated with Carl Marks & Co., Inc., foreign securities specialists. I am a

senior staff member and the executive director of the firm's special commitments department. Dr. Forcade is our firm's international legal adviser.

In our previous testimony on H.R. 8000 before the House Ways and Means Committee and in our subsequent summary and report to the members of that committee, we stated, and we now reiterate, that H.R. 8000 was not and cannot be an effective means of combating the balance-of-payments problem.

Whatever beneficial results the pending bill is claimed to have had because of its feature of retroactivity, are already more than offset by its detrimental side effects. Its enactment into law would only aggravate the situation.

The bill, in its present form, continues to be basically ineffective, since it covers only a very small portion of the outflow of capital in the private sector, and because it does not reach the principal sources of our balance-of-payments deficit and tackles the problem from the wrong end.

The amendments recently recommended by the Treasury Department do not materially change our views in that respect, and these latest suggestions, directed at technical problems which have been raised since the House committee's passage of the bill, would not make H.R. 8000 less of a monetary control and trade restriction of grave international consequence than the original version was.

This unilateral measure is now claimed to occupy a central position in the Treasury Department's total effort to achieve prompt and lasting improvement in our balance of payments by reducing the flow of long-term portfolio capital from this country.

Such central position is a far cry from the July 1963 version, wherein the Treasury referred to this interest equalization measure as a special temporary excise tax proposal, designed to be one step in a series of coordinated actions to reinforce the administration's program to correct the U.S. balance-of-payments deficit.

We fail to see the reason why all of a sudden, after a 6-month delay, H.R. 8000 has gained such prominence and is to be rushed through the Senate on very short notice.

If this overwhelming sense of urgency, which we do not share, and which we do not consider justified, should move this committee, then we specifically request that the committee amend the measure to minimize the damage which it will do, both to the American investors and to our international economic position.

It is quite true that the threat of this tax, overhanging our market since the July 1963 Treasury Department's release, has greatly reduced the flotation of new foreign issues on the American market, but it is also true that much of that international business has gone to European financial centers and with it a good deal of exports of goods and services that our country used to supply.

I am not talking pro domo on this point, since we are not in the underwriting business, nor exporters of goods and services, but I cannot fail to see, and to regret, the gradual loss of our country's position as the leading international bankers and purveyors to the free world, ever since this measure has been under consideration.

If the abnormal outflow of dollars, due to the sale of "new" foreign issues on our markets during the first half of last year, prompted the

Treasury to devise this excise tax proposal, rather than coping with the situation through other means, why then should "old" outstanding foreign securities also be barred from normal international trading and arbitrage by means of a high tariff, if it is an acknowledged fact that transactions in outstanding issues have improved our balance of payments?

We find no provisions in the Treasury Department's recommended amendments which would tend to restore this activity, which after all is a substantial asset to our economy, nor are there provisions of safeguards which would at least enable American holders of an estimated $10 billion worth of outstanding foreign securities—as opposed to prospective investors in new foreign issues—to protect their existing portfolio holdings which are specifically exempt from the taxation, through what is often referred to as "switching."

The term "switching" in this context refers to the exchange, conversion, substitution, and/or reinvesting of one's—tax-free and/or tax-paid—holdings. Switching is an entirely normal operation, whenever in the opinion of the owner, a change in his portfolio from one to another outstanding "old" issue is deemed advisable. Under the present proposal the holder is frozen in, since such transactions would be taxable, the same as any new acquisitions.

Obviously such switching does not in any way involve an outflow of dollars and such activity would, at least to some extent, restore confidence in our free enterprise institutions which H.R. 8000 tends to destroy.

On the other hand, the change of conditions brought about by H.R. 8000 has produced an, I believe, unprecedented increase in the outflow of dollars in the form of commercial bank loans. We find no dampeners of this type of outflow of funds among the Treasury Department's recommendations, nor for the possible wholesale outflow of funds via the avenue of "direct" foreign investments, which H.R. 8000 specifically also exempts from interest equalization taxation.

In this respect, I would like to bring to the committee's special attention the adverse comments on this subject, such as the New York Times editorial of last Thursday, headed "Controlling Capital Outflow." A copy of that editorial is attached to the copies of this testimony filed with the committee staff's office.

(The editorial referred to follows:)

CONTROLLING CAPITAL OUTFLOW

The Treasury has been seeking to stem the outflow of dollars caused by foreign borrowings in the United States as well as by American corporations investing abroad. Its main weapon is its controversial interest-equalization tax, which is to be levied on American purchases of foreign securities. Since this tax was first announced last July foreign borrowings have diminished. But the measure has flaws, and the Treasury has just issued a series of amendments to its proposal that is now before the Senate Finance Committee.

As long as the Nation faces a balance-of-payments problem, controlling the flow of capital is essential. Yet, as we have previously pointed out, the proposed interest-equalization tax is an effective control only in its present uncertain form. It is unlikely to stem the outflow of capital when its provisions are spelled out to potential foreign borrowers. The initiative, even after amendments, will still rest with foreigners, who will be free to borrow as much as they want provided they are willing to pay the higher costs for capital that the Treasury is seeking to impose.

We continue to believe that a capital issues committee operated by the Treasury and the Federal Reserve would be a more efficient and effective instrument of control. It would mean that Washington, and not foreign borrowers, would have responsibility for the size of the flow. It could be used also to regulate direct investment by American corporations, which accounts for a large part of the outflow but is not affected by the proposed tax.

Controls of any kind are unpleasant, but if we must have them, then we should be sure that they can do the job. As John Kenneth Galbraith observes, a capital issues committee is a "more effective procedure" than a new tax, for it can be employed when capital outflows must be controlled and lifted when the danger has passed. The kind of tinkering the Treasury is doing simply testifies that its plan is vulnerable to leakage. The objective can be accomplished much more successfully by direct control over capital.

Mr. GAREISS. Whether a capital issues committee such as referred to in the Times editorial and operated by the Treasury and the Federal Reserve is the best solution, would be for the Senate Finance Committee to decide. If nations can agree on lowering tariff barriers, or enforcing disarmament policies and work out space programs and other difficult problems, why should a capital issues committee not be feasible?

It appears to us, that decisions on the basis of individual merits are preferable to an excise tax equally applying to a new issue, the proceeds of which will serve to buy goods and services in our country, as compared for instance, to some foreign debt refinancing operation from which our Nation would derive little or no benefits.

However this may be, there has been, for the past 6 months, no true emergency requiring an interest-equalization tax. If there had been, the Senate would have told us. In our view, no such emergency exists today and there will be no such emergency in the foreseeable future. H.R. 8000 with its unique feature of retroactivity has served its purpose and outlived its usefulness. The balance-of-payments problems is under attack from many other standpoints and we believe quite successfully so.

Our firm has been in the foreign securities business ever since our country first became a creditor nation in the mid-1920's, and we have been active in this field through three wars and numerous varied phases of international monetary restrictions and foreign and domestic governmental control measures.

On the basis of this experinece and in the light of the current events, we firmly believe that H.R. 8000 is detrimental to the general interest of the United States; that its enactment will hurt this country in many ways; and, that even in the balance-of-payments field it will not significantly help in the short run and adversely affect us in the long run.

Therefore, we oppose the bill in its present form and urge this committee to reject it. This cannot possibly infer that we take lightly the imbalance of payment. It just means that we consider the bill totally inadequate. I thank you.

The CHAIRMAN. Thank you very much, Mr. Gareiss.

Are there any questions?

Senator BENNETT. No questions. I would just like to thank Mr. Gareiss for bringing up this question of switching. This is another new reason why the bill should not be passed, which, so far as I know, has not been suggested by another witness today.

The CHAIRMAN. Thank you, sir.

Senator DIRKSEN. Mr. Gareiss, could you make a memorandum for the committee indicating the structure of the so-called Capital Issues Committee which sets out the details so as to bring it directly to focus for our attention?

Mr. GAREISS. Senator Dirksen, the organization that I am representing here today is not, as I believe was mentioned in my earlier testimony in the underwriting and "new" issues business. We are primarily dealers and "market makers" for outstanding foreign securities. We see the effect of new issues, we see what it does. I would be very happy to deliver to you whatever information we have. Much of it is, however, not our own view or our own opinion. I shall just try to give you the necessary material and then comment on that.

There have, however, been, and I believe there will be speakers tomorrow who have very advanced ideas on the various shadings of the Capital Issues Committee.

Senator DIRKSEN. Since you say in your statement that you see no reason why such a committee would not be feasible, then I think if you could get some structure that would indicate some of the powers that it would have, it would be a good guideline for the committee.

Mr. GAREISS. I shall be glad to do that; thank you, sir.

The CHAIRMAN. Thank you very much.

The next witness is Mr. Arthur A. Feder, of the Fund of Funds.

STATEMENT OF ARTHUR A. FEDER, THE FUND OF FUNDS, LTD.

Mr. FEDER. Mr. Chairman and members of the committee, my name is Arthur A. Feder. I am a partner in the firm of Roberts & Holland, 405 Lexington Avenue, New York, and I appear here as counsel for the Fund of Funds, Ltd., which is an Ontario-based, open-end investment company.

We are seeking an exemption from the interest-equalization tax for subscriptions by Americans working or living abroad to the stock of foreign corporations which invest exclusively in the United States. These investments by Americans living abroad imporve the U.S. balance of payments. There is no reason to subject these investments to a tax whose sole announced objective is that of improving the balance of payments.

THE FUND OF FUNDS, LTD.

The Fund of Funds, Ltd. (FOF) is an open-end investment fund, incorporated in Ontario, which offers shares throughout the world, except in the United States. Ninety percent of FOF's assets normally consist of shares of U.S. mutual funds; 5 percent of the corporation's assets consist of publicly traded shares of U.S. corporations that manare mutual funds; and the remainder consists of cash held awaiting investment or to facilitate redemptions of shares. FOF now has more than $60 million of assets, and commitments for further purchases of its shares now amount to an additional $180 million.

FOF now has 16,000 shareholders outside the United States—80 percent of them are foreigners and 20 percent are U.S. citizens residing

or working outside the United States. We do not offer these shares in the United States at all.

Both American and foreign investors purchase FOF shares because the fund offers them very important investment advantages. First, FOF offers a diversification of investment in U.S. mutual funds that a smaller investor normally cannot achieve. Secondly, by investing through FOF a small investor has available to him the services of a highly trained group of mutual fund experts who choose the mutual funds in which FOF will invest. Third, the investor has the advantage of continuing supervision of his investment after it has been made.

FOF is in a position, because it invests large amounts at a time, to shift its investments from mutual fund to mutual fund at a very low cost, if it decides that this is desirable as a matter of investment policy. A smaller investor could shift his investment from fund to fund only at exorbitant cost.

This constant supervision of his investment is particularly important to an investor, be he American or foreign, who is outside this country and therefore unable to properly supervise his own investments. As the Fowler task force report noted, a flow of information such as American investors receive daily with respect to the status of the investment market in the United States is simply not available abroad. This is particularly true as one moves further and further away from Western Europe. The bulk of our investors are outside Western Europe.

It is this combination of investment advantages, together with the efforts of a well-trained 1,200-man sales force, that has led to FOF's immense acceptance by investors throughout the world. The fund was first offered less than 2 years ago and today has more than $60 million in assets.

Actually, every investment made in FOF by Americans abroad and by foreigners improves the balance of payments. Because of the manner in which the balance of payments is calculated an American who is outside the United States is treated as if he were a foreigner. Therefore, every time an American abroad takes a dollar and invests it in FOF, which then takes it immediately and invests it in the United States, the balance of payments is improved by the amount of $1.

The overall effect of FOF's operations is to provide a powerful mechanism for improving the United States' balance of payments. For instance, in 1963 the net increase in portfolio investment by foreign persons in the United States was $301 million. In that same period FOF brought $24,800,000 of new investment funds to this country. Moreover, because these were investments in mutual funds, which are generally of a long-term nature, we regard these as a particularly desirable type of additional investment in the United States.

During that same period, people who invested this $24,800,000 in FOF and consequently in the United States also entered into periodic payment plans which will, over the next 10 years, bring another $98 million into this country. At present, these commitments for additional investments in the United States by Fund of Funds investors amount to $180 million, about 20 percent of them being commitments by Americans.

This enormous amount of investment has been obtained because the sponsors of FOF had been implementing the recommendations of the Fowler task force long before those recommendations were made.

First of all, we have an immense sales force throughout the world. Secondly, FOF translates its prospectus into French, Italian, Spanish, German, Dutch, and Portuguese and prepares other sales literature in Arabic and Chinese and Japanese. The sponsors of the fund constantly seek methods to expand their distribution in countries throughout the world.

Moreover, because FOF is represented locally throughout the world, it responds very quickly to local regulations or to the threat of local regulations which might tend to place restrictions on further investments in the United States by local residents. A sales representative who sees a threat to his livelihood will be very quick to try to prevent a foreign country from restricting the sales on which his livelihood depends.

In effect, we believe the Fund of Funds is helping the balance-of-payments situation by bringing to bear upon it the most powerful of weapons, in effect, the profit motive.

You will find attached to the statement which has been submitted to the committee a draft of a proposed amendment to H.R. 8000. If accepted, the amendment would exempt from the interest equalization tax investments of not more than $5,000 a year in the stock of a foreign corporation by an American residing or employed on a full-time basis outside the United States, if the foreign corporation met a series of strict requirements designed to insure that the fund or the corporation invests substantially all of its funds in the United States. The exemption would be available only if, on June 30, 1963, and at the close of every subsequent calendar quarter, the corporation's assets other than money and bank deposits consisted only of stock or debt obligations of U.S. corporations, debt obligations of the United States or its political subdivisions, or debt obligations of citizens or residents of the United States.

Furthermore, the draft would require that money and deposits in foreign banks constitute less than 5 percent of the foreign corporation's assets on each such date. This 5 percent allowance is necessary solely because of the constant flow of funds from abroad to the United States for investment and because some cash must be held abroad to permit rapid redemptions of shares.

The exemption would only be applicable if on June 30, 1963, and at the end of each subsequent calendar quarter less than 25 percent of the foreign corporation's shares were held of record by U.S. persons.

Lastly, it should be particularly noted that the proposed exemption would apply only to subscriptions to the shares of the foreign corporation, and not to purchases from foreign persons of its shares. This will assure that each dollar invested by an American abroad under this exemption will result in a corresponding new investment in the United States.

In sum we ask that this amendment be made in H.R. 8000 because it will advance the fundamental aim of that bill—the improvement of the balance of payments.

(The attachment to Mr. Feder's statement follows:)

EXEMPTION FOR ACQUISITIONS OF STOCK OF FOREIGN CORPORATIONS INVESTING EXCLUSIVELY IN THE UNITED STATES

Present subsection (g) of section 4914 should be renumbered as subsection (h) of section 4914. The following should be added as subsection 4914(g):

"(g) ACQUISITIONS OF STOCK OF FOREIGN CORPORATIONS INVESTING EXCLUSIVELY IN THE UNITED STATES.—

"(1) IN GENERAL.—The tax imposed by section 4911 shall not apply to the direct acquisition from a foreign issuer of its stock by a United States person who is a bona fide resident of a foreign country within the meaning of section 911(a)(1), or who, at the time of such acquisition is performing personal services on a full-time basis in a foreign country, if at the close of the calendar quarter immediately preceding July 18, 1963, and at the close of every calendar quarter thereafter:

"A. The assets of such foreign issuer, exclusive of money or deposits with persons carrying on the banking business, consist solely of:

"(i) Stock or debt obligations of domestic corporations;

"(ii) Debt obligations of the United States or any political subdivision thereof; or

"(iii) Debt obligations of citizens or residents of the United States:

"B. Money and deposits with persons carrying on the banking business, exclusive of deposits in banks (as defined in section 581), constitute less than five percent of the value of the assets of such foreign issuer;

"C. Such foreign issuer does not own any stock or debt obligation, the acquisition of which by a United States person would be subject to the tax imposed by section 4911; and

"D. Less than 25 percent of each class of issued and outstanding stock of such foreign issuer is held of record by United States persons.

"(2) ACQUISITIONS THROUGH UNIT INVESTMENT TRUSTS.—An acquisition of an interest in a unit investment trust, within the meaning of section 4(2) of the Investment Company Act of 1940, or similar custodial arrangement shall be deemed a direct acquisition from the foreign issuer of the stock held by such trust with respect to such interest and shall not be treated as an acquisition of stock issued by the unit investment trust or similar custodial arrangement.

"(3) LIMITATIONS.—

"A. The exclusion provided by this subsection shall apply only to that portion of the total acquisitions of stock of foreign issuers (determined in the order acquired) described in paragraph (1) by a United States person in any one calendar year that does not exceed $5,000.

"B. If, as of the close of any calendar quarter a foreign issuer fails to satisfy the requirements contained in paragraph (1), then the exclusion provided by this subsection shall thereupon cease to apply with respect to all calendar quarters after such calendar quarter.

"C. The provisions of this subsection shall be inapplicable in any case where the acquisition of stock of the foreign issuer is made with an intent to sell, or offer to sell, any part of the stock acquired to United States persons."

In order to conform section 4914:

(a) Subsection 4914(b) should be amended by adding the following paragraph:

"(8) Acquisitions by Nonresident Citizens of Stock of Foreign Corporations Investing Exclusively in the United States.—Of stock by nonresident citizens to the extent provided in subsection (g)."

The CHAIRMAN. Thank you very much.

Senator BENNETT May I ask one question?

Is the Fund of Funds unique, or are there other funds operating under approximately similar terms?

Mr. FEDER. So far as we know, sir, we are the only fund of this type any place in the world.

Senator BENNETT. That is all. Thank you.

The CHAIRMAN. Thank you, Mr. Feder.

The next witness is Mr. William L. Sheets, of the National Constructors Association.

STATEMENT OF WILLIAM L. SHEETS, NATIONAL CONSTRUCTORS ASSOCIATION; ACCOMPANIED BY LOREN OLSON, DIRECTOR, FLUOR CORP., LTD., LOS ANGELES; AND JOHN CLARK, OF DAVIES, HARDY & SCHENCK, NEW YORK

Mr. SHEETS. Mr. Chairman, I have with me Mr. Loren Olson, who is director of the Fluor Corp., Ltd., of Los Angeles, and Mr. John Clark, partner in the law firm of Davies, Hardy & Schenck in New York.

My name is William L. Sheets, I am vice president and a director of Stone & Webster Engineering Corp., of Boston, Mass. Stone & Webster is one of the oldest engineering and construction firms specializing in the design and erection of large-scale industrial plants, including power-generating facilities, oil refineries, and atomic energy installations. It is known both nationally and internationally. Stone & Webster is an active member of the National Constructors Association. I am appearing today in this matter as a representative of that association and as its vice president.

The association, known as NCA, is composed of 30 large engineering and construction companies. They specialize in the design and erection of large-scale industrial facilities, chemical and petroleum plants, steel mills, power stations, and the like.

Taken as a group, these firms have designed and erected a significant portion of the industrial plant of the United States. The interests of many of these member companies extend beyond our national limits to include countries throughout the free world. An informational folder is attached which lists the association's membership, its officers, and its major committees.

(The folder referred to follows:)

NATIONAL CONSTRUCTORS ASSOCIATION, WASHINGTON, D.C.

MEMBERS

The Badger Co., Inc., 363 Third Street, Cambridge, Mass.
Bechtel Corp., 220 Bush Street, San Francisco, Calif.
Blaw-Knox Co., Chemical Plants Division, 300 Sixth Avenue, Pittsburgh, Pa.
C. F. Braun & Co., 1000 South Fremont Avenue, Alhambra, Calif.
C. & I./Girdler Corp., 256 McCullough Street, Cincinnati, Ohio.
Chemical Construction Corp., 320 Park Avenue, New York, N.Y.
Day & Zimmermann, Inc., 1700 Sansom Street, Philadelphia, Pa.
Dravo Corp., Machinery Division, Dravo Building, Pittsburgh, Pa.
Ebasco Services, Inc., 2 Rector Street, New York, N.Y.
H. K. Ferguson Co., Ferguson Building, Cleveland, Ohio.
Fluor Corp., Ltd., 2500 South Atlantic Boulevard, Los Angeles, Calif.
Ford, Bacon & Davis Construction Corp., Post Office Box 1762, Monroe, La.
Foster Wheeler Corp., 110 South Orange Avenue, Livingston, N.J.
Hydrocarbon Research, Inc., 115 Broadway, New York, N.Y.
Kaiser Engineers, Division of Henry J. Kaiser Co., 300 Lakeside Drive, Kaiser Center, Oakland, Calif.
M. W. Kellogg Co., 711 Third Avenue, New York, N.Y.
Koppers Co., Inc., Engineering & Construction Division, Koppers Building, Pittsburgh, Pa.
Lummus Co., 385 Madison Avenue, New York, N.Y.
Arthur G. McKee & Co., 2300 Chester Avenue, Cleveland, Ohio.
J. F. Pritchard & Co., 4625 Roanoke Parkway, Kansas City, Mo.
Procon, Inc., 1111 Mount Prospect Road, Des Plaines, Ill.
Rust Engineering Co., 930 Fort Duquesne Boulevard, Pittsburgh, Pa.
Sanderson & Porter, Inc., 72 Wall Street, New York, N.Y.

Stearns-Roger Corp., 660 Bannock Street, Denver, Colo.
Stone & Webster Engineering Corp., 49 Federal Street, Boston, Mass.
United Engineers & Constructors, Inc., 1401 Arch Street, Philadelphia, Pa.
Wilputte Coke Oven Division, Allied Chemical Corp., 40 Rector Street, New York, N.Y.

ASSOCIATION MEMBERS

The Babcock & Wilcox Co., Erection Department, 20 Van Buren Aveune South, Barberton, Ohio.
Combustion Engineering, Inc., Prospect Hill Road, Windsor, Conn.
Graver Tank & Manfacturing Co., Division—Union Tank Car Co., 111 West Jackson Boulevard, Chicago, Ill.

REGIONAL LABOR COMMITTEE CHAIRMEN

East coast: J. M. Graney, Ebasco Services, Inc.
Great Lakes: Rex Vermilyea, Badger Co., Inc.
Gulf coast: T. Lawrence Cronin, Lummus Co.
Midcontinent: Ted Orme, Stearns-Roger Corp.
West coast: Ken Weston, Fluor Corp., Ltd.

ACCIDENT PREVENTION COMMITTEE

Chairman: F. A. Campbell, J. F. Pritchard & Co.
Cochairman: William Fitz, Rust Engineering Co.

INTERNATIONAL COMMITTEE

Chairman: J. T. Wolcott, the H. K. Ferguson Co.
Cochairman: W. D. Lavers, Ebasco Services, Inc.

PUBLIC AFFAIRS COMMITTEE

Chairman: J. F. Quinn, Procon, Inc.
Vice chairman: P. S. Lyon, J. F. Pritchard & Co.

LABOR COST COMMITTEE

Chairman: Paul L. Wetcher, C. F. Braun & Co.
Vice chairman: J. J. O'Donnel, Bechtel Corp.

OFFICERS

H. A. Denny, president.
W. L. Sheets, vice president.
E. D. Hoekstra, executive secretary.

EXECUTIVE COMMITTEE

Eric Miller, manager, industrial relations overseas, Bechtel Corp.
Thomas W. Hopper, executive vice president, operations, Day & Zimmermann, Inc.
George O. Phillips, executive vice president, Ford, Bacon & Davis Construction Corp.
H. A. Denny, vice president and general manager, Engineering & Construction Division, Koppers Co., Inc.
James C. Reed, executive vice president, Procon, Inc.
Niels K. Steenhill, vice president, Rust Engineering Co.
W. L. Sheets, vice president, Stone & Webster Engineering Corp.

FORMER PRESIDENTS

J. F. O'Connell, Bechtel Corp.
J. J. O'Donnell, Bechtel Corp.
P. L. Wetcher, C. F. Braun & Co.
H. E. Lore, Dravo Corp.
D. W. Darnell, Fluor Corp., Ltd.
W. R. Wood, Girdler Corp.
G. F. Bayes, M. W. Kellogg Co.
G. R. Collins, Lummus Co.
J. F. Pritchard, J. F. Pritchard & Co.

Carl B. Whyte, Procon, Inc.
C. D. Haxby, Rust Engineering Co.
T. C. Williams, Stone & Webster Engineering Corp.

LABOR COMMITTEE

Chairman: W. Leo Walsh, M. W. Kellogg Co.
Vice chairman: J. Warren Evans, J. F. Pritchard & Co.
Rex Vermilyea, Badger Co., Inc.
R. E. Atkinson, Bechtel Corp.
D. E. Mays, Blaw-Knox Co.
Elliott B. Condon, C. F. Braun & Co.
P. K. Kintz, C. & I./Girdler Corp.
J. F. O'Neill, Chemical Construction Corp.
Thomas R. Kenney, Day & Zimmermann, Inc.
G. T. Leonard, Dravo Corp.
J. M. Graney, Ebasco Services, Inc.
Ben T. Cherry, H. K. Ferguson Co.
Ken Weston, Fluor Corp., Ltd.
B. O. Yeldell, Ford, Bacon & Davis Construction Corp.
J. G. Hand, Foster Wheeler Corp.
C. C. Balding, Hydrocarbon Research, Inc.
Bert Hartford, Kaiser Engineers.
R. K. Matthews, Koppers Co., Inc.
T. Lawrence Cronin, Lummus Co.
D. A. Miller, Arthur G. McKee & Co.
R. A. Murray, Procon, Inc.
T. L. English, Rust Engineering Co.
W. J. Monaco, Sanderson & Porter, Inc.
Ted Orme, Stearns-Roger Corp.
V. D. Van Horn, Stone & Webster Engineering Corp.
R. J. Cunningham, United Engineers & Constructors, Inc.
G. J. Sullivan, Wilputte Coke Oven Division, Allied Chemical Corp.
H. C. Gransee, Babcock & Wilcox Co.
E. F. Jones, Combustion Engineering, Inc.
M. D. Kinghorn, Graver Tank & Manufacturing Co.

Mr. SHEETS. NCA concern with foreign construction, while secondary to domestic operations, has led to the formation within the association of an international committee. This is a standing committee which concerns itself with the specific problems involved in carrying out engineering design and construction operations abroad. To my knowledge, NCA is the only association of contractors with a continuing interest and a standing committee in this field.

With reference to H.R. 8000, the NCA is deeply concerned and recognizes fully the need for any reasonable measure which will reverse the trend of the balance-of-payment problem with its resultant drain upon our country's gold supply. This is a goal behind which the full strength of our Nation should be mustered.

The principal provisions of this proposed act are aimed at the outflow of dollars from this country in the purchase of equity or debt interests in foreign enterprises. By these provisions the act penalizes the passage of funds beyond our borders for purely investment purposes.

The bill in section 4914 recognizes certain exceptions to this passive investment situation and provides for various exclusions from the penalty tax where the investment in foreign equity or debt securities is necessary to insure the maintenance of a competitive position with non-U.S. concerns engaged in the same line of endeavor.

The provision for the exception of the acquisition of foreign investments as a concomitant necessity of active business transactions by U.S. interests is proper to maintain the strength of U.S. business

activities abroad as well as to continue the ever-increasing vitality and growth of industry and employment within the borders of our Nation.

In the foreign activities of our major construction and engineering concerns, particularly because of the huge amounts of money which may be involved in a single contract or project, the problems of financing for the foreign principal will often necessitate that the contracting firm agree to accept a portion of the contract price in either debt obligations or stock issued by the foreign principal. This requirement is given emphasis by the willingness and eagerness of certain countries in Western Europe to subsidize the extraterritorial activities of our foreign competitors by underwriting the necessary acquisition of debt obligations and stock.

A recent survey has shown that over a 5-year period, the total volume of foreign business performed by NCA members amounted to at least $2 billion, a significant amount of which was spent in the United States for labor, equipment, materials, and services. Translated into man-hours, it has been conservatively estimated that loss of this foreign business would result in a decrease of 24 million man-hours of employment per year within the United States. The maintenance of a continued flow of foreign business is contingent upon the ability of U.S. concerns to bid competitively against foreign firms upon terms which are reasonable as to the payment of compensation in the light of our national balance-of-payment situation.

H.R. 8000, as originally referred to the House Ways and Means Committee, did not contain provision for this situation, and would have taxed as a proscribed acquisition any receipt of foreign securities by domestic construction firms under the circumstances which have been outlined.

Based upon a statement on behalf of this association before the House Ways and Means Committee, there was inserted in the proposed act section 4914(c)(2) which provides for a limited exclusion from the impact of the interest equalization tax in situations where sales of products and/or services to foreign principals are financed in whole or in part by the receipt of foreign debt oblgations or stock. This exclusion is grounded upon a twofold test, both parts of which must be met for the exclusion to apply. These tests are:

1. Thirty percent of the total contract or purchase price must be attributable to a combination of the performance or services by the U.S. firm and the sale of property produced, manufactured, grown, or extracted by the U.S. firm; and

2. Fifty percent of the total contract or purchase price must be attributable to a combination of the performance of services and the sale of property manufactured, produced, grown, or extracted in the United States by U.S. persons.

This twofold test represents a realistic and workable solution to the problem of foreign competitive conditions with one exception: the percentage limitations are applied to the wrong factor and one which bears no logical relationship to the basic purposes of the proposed act. If the total consideration for extraterritorial construction contracts consisted of equity or debt securities of foreign corporations, this test would be logical, but in actual practice only a minor portion of the consideration for such contracts is met in this manner with the larger portion being met with cash payment.

Taken as a premise that this bill is designed to discourage the outflow of dollars in exchange for foreign securities, it follows that any standard to be applied to determine taxability or exclusion with relation to a transaction in connection with active business should be based not upon the total volume of business done, but upon that portion of the transaction which involves the receipt of foreign securities.

Thus it is the association's position that the 30-percent and 50-percent test prescribed by section 4914(c) (2) of the proposed act should be applied not to the total contract or purchase price of a particular project but to that portion of the contract price which is to be paid by the transfer of foreign securities.

To illustrate this, let us assume a foreign job on which the total contract price is $20 million. If the present tests in the proposed act were applied, it would be necessary that $6 million of the total contract price be attributable to services performed and property manufactured or produced in the United States by the construction firm and that $10 million be attributable to U.S. products and services.

This would be true whether the debt obligations to be received under the contract amounted to the full $20 million which would involve an unfavorable balance-of-payments flow of $10 million or whether the debt obligation was only $1 million which would result in a favorable payment flow of $9 million.

In most cases an engineering construction firm does not manufacture or produce the physical components of a project so that as a practical matter in this case $6 million of the total contract price of $20 million must be able to be attributed to the services of the contracting firm in order to exempt any or all of the debt obligations from the imposition of the penalty tax regardless of how much is involved. It is obvious that such a test is virtually impossible of fulfillment.

The more realistic standard proposed by NCA here is that the 30-percent and 50-percent tests of section 4914(c) (2) be applied to the amount of the foreign debt obligations and stock to be received as part of the transactions excluding from consideration the cash payments with which the proposed act is not concerned. This test would serve to keep within reasonable bounds the performance of foreign construction projects upon payment in the form of foreign securities and would still enable U.S. concerns to maintain their competitive position in the international market preserving this segment of our industry which is so vital to our economy.

We wish to point out a second serious problem which the bill in its present form would impose upon U.S. engineer-constructors engaged in foreign work. This relates to uncertainties as to tax applicability at the time a U.S. firm is bidding on a foreign project.

The type of project performed by NCA members in many cases extends over a period of several years from inception to completion. During that period of time, conditions may change and it is conceivable that the proportion of the final contract price represented by debt obligation and stock to be accepted as part payment could increase.

Such a proportionate increase might cause a failure to meet the tests of section 4914(c) (2) and subject to the penalty tax the entire amount of debt obligation and stock received. The possibility of such a result could substantially reduce the incentive for bidding upon foreign construction projects.

It is accordingly proposed by NCA that the 30-percent and 50-percent tests be applied as limitations upon a basic exemption from the tax and that the tax be imposed upon debt obligations and stock only to the extent that they exceed the amounts permitted to be received by the application of such standards.

To implement the foregoing proposals, the following revision of section 4914(c)(2) is submitted for consideration:

(c) Export credit, etc., transactions.—

(2) Alternate rule for producing exporters.—The tax imposed by section 4911 shall apply to the acquisition by a United States person of such portion of the actual value of stock and debt obligation of a foreign issuer or obligor in payment for the sale of tangible personal property or services (or both) to such issuer or obligor which exceeds the lesser of (A) or (B).

(A) Three hundred and thirty-three percent of the amount of the purchase price attributable to the sale of property manufactured, produced, grown, or extracted in the United States by such United States person (or by one or more includible corporations in an affiliated group, as defined in sec. 1504, of which such person is a member), or to the performance of services by such United States person (or by one or more such corporations), or to both.

(B) Two hundred percent of the amount of the purchase price attributable to the sale of property manufactured, produced, grown, or extracted in the United States, or to the performance of services by a United States person, or to both.

Since the stated purpose of H.R. 8000 is to curb the long-term capital outflow from the United States, the amendments we propose are consistent with that purpose as interpreted in the present proposed act, and will eliminate the possibility of placing a serious curb upon foreign engineering and construction activities of U.S. concerns, an activity which is demonstrably vital to our national economy.

The CHAIRMAN. Thank you very much, Mr. Sheets.

Any questions?

Senator BENNETT. May I ask one question, Mr. Chairman?

Are these standards contained in the House bill written there in defiance of similar testimony to the House, or were they written in without your knowledge and this is the first opportunity you have had to point out their weaknesses?

Mr. SHEETS. This is the first opportunity that we have had a chance to discuss the matter.

There was nothing in the original bill to cover this particular situation. The Treasury Department, as I understand it, wrote this and submitted it and they used their best efforts, I think, to cover the points that we made when we appeared before the House Ways and Means Committee. But it does not cover all of the conditions that could develop.

Senator BENNETT. You did appear before the Ways and Means Committee?

Mr. SHEETS. I did, sir.

Senator BENNETT. Did you point out approximately the same problem that you have pointed out to us?

Mr. SHEETS. No, we did not, sir, not to that extent. I do not know that I have the things that we submitted. But a great many of the things, or many of the things that we suggested, were incorporated in the bill as it presently stands. But as you read it now, you begin to see these other possibilities that could hurt you.

Senator BENNETT. So this is, in effect, new testimony?

Mr. SHEETS. This is, in effect, new testimony, sir.

Senator BENNETT. That is all, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Sheets.

The committee will stand in recess until tomorrow morning at 10 a.m., when we shall hear additional witnesses.

(Whereupon, at 11:50 o'clock, the committee was recessed, to reconvene at 10 a.m., Thursday, July 2, 1964.)

INTEREST EQUALIZATION TAX ACT

THURSDAY, JULY 2, 1964

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd (presiding), Douglas, McCarthy, and Bennett.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

Senator Javits, we are delighted to have you here.

STATEMENT OF HON. JACOB K. JAVITS, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator JAVITS. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement which I would like to file with the committee. I will paraphrase some parts of it, but I think I shall cover the essential elements.

First, I went to thank the committee for the opportunity to testify on this very important matter, which is of great interest to my constituency, the New York financial community.

Now, Mr. Chairman, the highlights of my testimony are as follows:

I feel that we are dealing here with an effort to impose a new kind of protective tariff, this one on the import of foreign securities. Viewed from another point of view, it would impose a levy on the export of American capital. First and foremost, it is a most significant break with the American tradition. We have grown in power and consequence as a nation because we were a free, not a controlled capital market. In peacetime, under conditions which do not warrant it, the approach proposed in this bill marks such an extraordinary break with our past and with our destiny as to call for, in my judgment, far more profound consideration than it has had.

Only some emergency of the most urgent kind would justify such a very serious break with the tradition of the United States as the banker for the world a position which gives us the very power and authority which so heavily contributed to our peace leadership and to its effectiveness.

Mr. Chairman, this tax is a form of exchange control, one with limited effectiveness. It is a proposal specifically designed to control and restrict the movement of capital.

34-937—64——16

This measure would not achieve even its basic objective, to equalize the costs of longer term financing in the United States and in markets abroad. In a letter addressed to me on May 28, 1963, Secretary Dillon himself said, and I quote, "Even if long-term interest rates rose above those in Europe and Japan, we would expect foreign governments and corporations, particularly those needing relatively large amounts of money, to resort to the highly developed U.S. market."

Even after a 1-percent increase in the interest cost of foreign borrowers in the United States market—which is the effect desired by the Treasury—it is expected by competent authority that it will still be cheaper or as cheap to borrow here as in most European countries. As underwriting costs are much lower and distribution opportunities are much greater through the United States than through European distribution, I predict, Mr. Chairman, that if we should be unwise enough to adopt this tax, we will be right back where we started from, except that we will have fractured our reputation for being the banking center of the world in the process.

Now, it is argued by the Treasury that there have been no major foreign flotations since this act has been on the books. The only reason for that is that you cannot negotiate with an uncertainty. This tax is retroactive in its effect, and therefore you do not know whether you are going to have it or not. In major security issues, a fraction or a 1-percent change in interest costs makes a very great difference.

The sale of new foreign securities so far as the United States is concerned, has diminished except for those areas, Mr. Chairman, where there are going to be exemptions anyhow, such as for Canadian and the Japanese securities, and for commercial bank loans. I will give the figures on a perfectly extraordinary skyrocketing of commercial bank loans which indicates that U.S. capital is still going out, it is only going out in a different form, and, in my judgment, and I state this as a positive prediction, Mr. Chairman, the outflow will be restored to exactly what it was, notwithstanding the tax, and we will be the laughing stock of the world because we are amateurs.

That is what this tax is all about. It is a completely amateur approach to a major, professional problem.

Mr. Chairman, President Kennedy's assertion that we have got to simplify our tax structure and reduce our trade barriers is still valid today. This is a bill to complicate our tax structure and to increase our trade barriers.

You had testimony here only the other day by an expert whose testimony remains unchallenged, that this tax would affect only about 10 percent of total private U.S. capital exports. This was testified to on behalf of the Association of Stock Exchange Firms by Mr. Andries D. Woudhuysen, a partner in Burnham & Co., of New York. In the first place, you are exempting Canada, the major seller of new foreign securities before the tax was proposed. In the second place, much of our capital could be exported by direct investment, which is bound to come in to fill in the gap, and by U.S. institutional investors, banks, insurance companies, and the like, who are able to buy foreign securities abroad without incurring the penalty of the proposed tax.

Now, the foreign borrower has, as I said a minute ago, very heavily funneled into the commercial bank loan route which is exempted under

this proposed statute. U.S. commercial bank loans to foreigners have increased very materially since the tax was proposed. Preliminary Treasury, Commerce, and Federal Research Board figures indicate that commercial bank loans to foreigners have more than tripled, from approximately $400 million in 1962, to $1,280 million in 1963. Direct investments exempt from the tax have exceeded the net outflow caused by new securities in every year since 1960, including 1963 and the first quarter of 1964.

The bill also provides exemption from the tax on original or new issues if the President determines it to be required for the stability of the international monetary system. This loophole could further limit its effect on the U.S. balance of payments. The whole measure has been materially weakened by the numerous exemptions to which I have referred.

The bill would exempt major buyers of foreign securities. It would exempt from the tax purchases involving 10 percent or more of the total combined voting power of all classes of stock of a foreign corporation. It would discriminate against the small investor.

Indeed, the tax might well worsen instead of improve our balance of payments and for this reason. When you compare the unfavorable effect caused by the sale of foreign securities to Americans with the favorable impact of an export surplus on our balance of payments, the latter completely overshadows the former. We have the authority of Prof. Lawrence Krause of the Brookings Institution who says that you may deter some capital flow by putting on this tax, but you pay for it in lower exports or some other feedback in the balance of payments. So the program to tax American capital investments abroad may offset the benefits of efforts to increase U.S. exports.

It is interesting, Mr. Chairman, that here is a tax which has no friends of any kind or character. Nearly every witness before this committee and before the House Ways and Means Committee questioned about this tax either opposed it or supported it with only the greatest reluctance on the grounds that, well, what else can you do?

This tax is flagged as temporary, but we have had a lot of experience around here with so-called temporary taxes, like the excise tax, and this could easily be another Sinbad on the back of the whole American financial system. Nonetheless, notwithstanding the general lack of enthusiasm for this tax, the administration continues to press for its approval with the unconvincing argument that if the bill does not pass, foreigners will feel that the United States is not serious about eliminating its balance-of-payments deficit. In fact, Mr. Chairman, rejection of the tax will strengthen the confidence of foreigners in our determination to adhere to our basic and oft-stated principles of national policy to support free and open world markets for goods and capital. Thus far we have tried to improve our balance-of-payments position through such means as to boost up our exports, to make efforts to reduce our foreign procurements, to even curtail, if necessary, some tourist expenditures, which are enormous, completely overshadowing what this tax would do abroad, something in the area of $2 billion. We are also trying to get other nations to assume greater international responsibilities in terms of Western military defense and economic aid to the world. These are really meaningful measures. Mr. Chairman, this tax equalization bill is "amateur hour" in comparison.

The persistence of our balance of payments, Mr. Chairman, is not attributable to private investment abroad. Receipts from dividends and interest on U.S. investment abroad have consistently exceeded net outflows of U.S. capital to foreign countries every year except in the period 1957–58, and that includes 1963. In 1963, income enjoyed by the United States on its foreign investment accounts has been estimated at $4.3 billion, the largest income item on the U.S. balance of payments. Should H.R. 8000 be enacted, we would be flying in the face of this experience.

I shall conclude with a comment on developments both here and abroad which call for a reappraisal of the need for this bill now.

Since the introduction of this measure, there have been several important developments which already have and will continue to have in the future not an unfavorable but a favorable impact upon our balance of payments. The condition of economic growth in Europe and the relatively slow growth in the United States has been reversed. We are doing better now than the Europeans, and the Europeans are beginning to feel—not that we want them to do anything but well, but it is the fact of life—the squeeze produced by shortage of workers, increasing production costs and spiraling profits, and they are now subject to the familiar cost-profit squeeze just as we were for such a long time.

European capital markets have expanded their internal lending activities significantly in recent years. This is a conclusion reached by the Treasury itself in a study entitled "A Description and Analysis of Certain European Capital Markets" prepared for the Joint Economic Committee in connection with its study last year of the U.S. balance of payments, and this expansion has already resulted in increased markets for foreign securities in Europe.

Since the passage of the tax cut earlier this year, our investment climate has improved, and hence, we have attracted a great deal of U.S. investment which would otherwise have gone abroad. This improvement may also attract additional foreign investment to the United States. The key figures, of course, are very well known. The most important figure to me is the investment in capital goods, especially by business and industry, which was 3 percent higher during the first quarter of 1964 than had been anticipated even as late as December 1963. Total investment in plant and equipment for 1964 is expected to reach $43.9 billion, 12 percent above 1963 as a whole. Between 1962 and 1963 such investment increased by only 5 percent.

Another factor that must be considered is that we are substantially expanding our exports. Between 1962 and 1963, U.S. merchandise exports increased by $1.4 billion, from $20.6 to $21.9 billion, compared with an increase of $566 million between 1961 and 1962. And in the first quarter of this year our exports are running at an annual rate of over $24 billion, 21 percent higher than in the first quarter of 1963.

This increase may not be sustained throughout the year, but stability of prices in the United States and continued inflation in Europe, more effective export promotion techniques of which we are just beginning to get the benfit, would indicate that we will have very materially improved export balance conditions. Also our gold outflow has declined substantially in 1963. Our gold stock declined by $460

million as compared with $900 million in 1962, and during April 1964, we actually have an increase in gold stock of $178 million.

The most regrettable aspect of this interest equalization tax, Mr. Chairman, is that it is another piecemeal attempt to deal with a problem which is much more fundamental, and that is the inadequacy of the international monetary system. We are attempting, through various classic means, to improve our balance-of-payments problems, including export expansion, tourist promotion and the increased sharing with our allies of responsibilities with regard to the common defense and economic aid to developing nations. This bill represents tinkering of a most primitive character with capital flows, without getting at the root of the problem.

The so-called Paris Club and the International Monetary Fund are presently engaged in reappraisal designed to improve the international monetary system so that we or any other country should not get in this kind of a jam merely on the basis of a balance-of-payments situation which is a transitory nature. I would look to this reappraisal for fundamental answers to the long-term solution of the balance-of-payments problem.

Now, finally, Mr. Chairman, what about alternatives? I would like to propose two alternatives, both of which I have had printed as amendments for submittal to the committee.

One alternative is an amendment to the pending bill, and this would exempt from the tax up to 25 percent of the distribution of any new bond or stock issue which is distributed in the United States. The basis of that amendment is that if you exempted that much, you would make available to foreigners, something in the area of $600 to $700 million in U.S. capital exports which the Treasury itself has said is a satisfactory figure. And it is my understanding, and this amendment is based on a plan submitted by Mr. Nathaniel Samuels (chairman of the Foreign Investment Committee) of the Investment Bankers Association of America—he is also a member of Kuhn, Loeb & Co., and he is here today—that this plan would accommodate the actual experience of the investment banking business in the United States. That is, they actually do distribute just about 25 percent of these issues in the United States. The rest is distributed abroad. And this would enable the U.S. capital market to operate in a way which would be conducive to precisely tailoring the means to the objective. I like it very much, and I submit it to the committee and urge it upon the committee, and I am sure Mr. Samuels will be glad to answer any of the technical questions with respect to it.

Secondly, I have submitted as a complete substitute for the interest equalization tax a specific proposal which would authorize a Capital Issues Committee. This is a proposal to which I have addressed myself before, and I point out, Mr. Chairman, that there is a precedent for that. The precedent that I have employed is section 708 of the Defense Production Act of 1950, and it was under the authority of that act that the Voluntary Credits Restraint Committee, established during the Korean war period, was set up. This amendment, as the committee will see by examining it, will completely accommodate any governmental controls which the President wishes to add either by way of maximums or minimums or constant consultation or any other form if a Capital Issues Committee is set up. Government controls

can be exercised either through Treasury, through the Federal Reserve Board, or through the individual Federal Reserve banks.

So here are two amendments, one which would keep the door open to the U.S. capital market, another which would be a complete substitute and authorize the creation of a Capital Issues Committee.

Now, I used the word, Mr. Chairman, on a number of occasions in discussing this before the committee, "amateur," and it is amateur because other countries, faced with the same problem, actually use the capital issues technique, and none of them have employed this rather strange alternative of an interest equalization tax.

I give you the following examples: In Switzerland, the United Kingdom, Netherlands, and France, the Capital Issues Committee, or forms of it are well-known institutions, advising the reviewing authority over foreign security issues, which usually are the central banks, on the advisability of new foreign security issues. I may add that the Capital Issues Committee technique has the support of respected members of a financial community in the United States including the Association of Stock Exchange Firms.

To sum up, Mr. Chairman, and this completes my statement, this bill is a completely amateurish approach to a highly professional problem. It is really not essential to the situation which we face. There are many other things which are infinitely more important. There has been great improvement in our situation since the bill was proposed, and on that ground it is no longer justified. The means are not at all tailored to the desired result. They are unlikely to achieve the result. I have suggested in one amendment a much better means to achieve the particular result of holding down our capital export on this ground to around $700 million a year yet making possible that the U.S. capital market continue to play an important role as a financial center.

And finally, the technique proposed in this bill is not the technique employed anywhere. On the other hand, established techniques which have been employed here and elsewhere are available and again proposed in the substitute which I have submitted to the committee.

I am very grateful to the Chair for allowing me this opportunity to appear.

(Senator Javits' statement in full is as follows:)

STATEMENT OF SENATOR JACOB K. JAVITS

I appreciate the opportunity to testify before this committee in opposition to H.R. 8000, the interest equalization tax bill, a measure which is of particular interest to me and to the New York financial community, and which has a critical bearing on the national economy.

Let me make it clear that I feel this measure is nothing more than a new kind of protective tariff which when enacted will not only be incapable of doing the job it is designed to do, but which can have a deleterious effect on the role of the United States as the financial center of the world. I also agree with the conclusions of many experts that there is no present emergency, and that there are alternatives better able to reduce our imbalance of international payments if any emergency arose. Of these alternatives, I believe that the creation of a Capital Issues Committee, under the guidance of the Treasury, would be most effective.

Since the President's balance-of-payments message last July, I have repeatedly addressed myself to this subject. I would now like to summarize my position on the bill:

1. I believe that the tax is a new protective tariff designed to limit the importation of foreign securities. Viewed from the opposite point of view it is a duty on exports of private capital for investment abroad. This is a significant departure from our traditional policies regarding the free flow of capital and our postwar multilateral approach. As significant, in fact, as would be a return to high protective tariffs on U.S. imports regarding our commitment to liberalize world trade. We would be setting a very bad example to the other countries of the Western World which we have urged to reduce their international trade barriers and to maintain, as much as possible, the highly desirable goal of free flowing capital and exchange of goods and services between friendly countries.

2. This tax would be an exchange control of limited capacity. It would be a tax specifically designed to control and restrict. It would delegate to the President discretionary powers of application and exemption.

3. As indicated in Secretary Dillon's letter to me of May 28, 1963, an increase in U.S. long-term interest rates—which would be the effect of the proposed tax on foreign investors—would not achieve the basic objective of this measure. The Secretary stated:

"* * * Even if long-term interest rates rose above those in Europe and Japan, we would expect foreign governments and corporations, particularly those needing relatively large amounts of money, to resort to the highly developed U.S. market * * *."

Even after a 1-percent increase in the interest cost to foreign borrowers in the U.S. market it will still be cheaper, or as cheap, to borrow here as in most European countries. Underwriting costs in Europe, for example, are considerably higher than in the United States so that even with the tax, borrowing in the United States may be more attractive than borrowing elsewhere.

Furthermore, a decrease in U.S. capital supplied to foreign markets will result in an increase in demand for foreign capital and a pressure for higher interest rates abroad. While the interest rate spread between the United States and Europe initially would be reduced by about 1 percentage point under the bill, the spread probably would return to approximately its pretax size after the offsetting increase in foreign rates that would likely result.

4. Still valid today are the sentiments expressed in a September 1, 1963, New York Times editorial:

"* * * The tax is difficult to reconcile with President Kennedy's assertions that the present tax structure must be simplified and trade barriers reduced. The addition of the tax would complicate the tax structure and would establish a tariff on capital, putting into effect a two-price system for funds. And despite the administration's claims that the tax will not interfere with the workings of the free market, it is clearly a form of control * * *."

5. The exemptions provided for in the bill exclude from the tax the major areas of capital outflow, taxing only a relatively insignificant total of transactions—about 10 percent of total private U.S. capital exports according to careful estimates of the Association of Stock Exchange Firms. These would include the purchase of foreign stocks and the purchase of new foreign bonds (other than Canadian, which are exempt) where the borrower is precluded from obtaining the funds from a bank. Since most lending abroad—and for the most part foreign bonds—are purchased by U.S. institutional investors such as banks, insurance companies, and the like, the net effect is to permit banks to lend money abroad tax free, but to deny to the other institutional investors the same right. The foreign borrower is "funneled" into the bank loan route. Interestingly, U.S. bank loans to foreigners have increased since the tax was proposed. Preliminary Treasury, Commerce, and FRB figures indicate that commercial bank loans to foreigners have more than tripled: From approximately $400 million in 1962 to $1.28 billion in 1963. I might also add that direct investments which are exempt from the tax, have exceeded the net outflow caused by new securities in every year since 1960, including 1963 and the first quarter of 1964. The bill also provides exemption from the tax on original or new issues where the President determines that it is required for the stability of the international monetary system. This loophole could severly limit its effect on the U.S. balance of payments, which is already weakened by numerous exemptions.

6. The tax would be inequitable because it would penalize the small investor who would be subject to the tax on the purchase of a few shares or a few bonds of a foreign corporation, while a large company, or a wealthy individual could purchase tax free a substantial interest in the same foreign corporation. The bill exempts from the tax purchases involving 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation.

7. The tax might very well worsen our balance-of-payments position. Dr. Lawrence Krause of the Brookings Institution has noted that "you must always distinguish between improving the balance of payments and stopping a capital flow. These are not identical. You may deter some capital flow and you pay for it in lower exports or some other feedback in the balance of payments." The program to tax American capital investments abroad thus may offset the benefits of efforts to increase U.S. exports.

8. Nearly every witness before this committee and the House Ways and Means Committee who was questioned about the interest equalization tax proposal either opposed it or supported it only with the greatest reluctance. Even its advocates have admitted that it would not be desirable as a permanent measure, yet experience suggests that such "temporary taxes" often become permanent.

In spite of this general lack of enthusiasm, the administration continues to press for its approval with the unconvincing argument that if the bill does not pass, foreigners will feel that the United States is not serious about eliminating its balance-of-payments deficit. In fact, rejection of this tax will strengthen the confidence of foreigners in the strength of our adherence to basic and oft-stated principles of a national policy of free and open world markets for goods and capital.

The proposed tax would erect an artificial wall to the free flow of private capital with longrun effects that would be damaging to both our domestic economy and our foreign economic policy. The New York Times commented editorially on July 24, 1963:

" * * * This measure is inconsistent with the position of the United States as the world's banker and with the longstanding objective of lowering barriers to trade and capital movements. Instead, it suggests that we are regressing toward direct controls over capital, which led to the breakdown of international finance a generation ago."

9. The persistent deficit in our balance of payments is not attributable to private investment abroad. As the Brookings Institution recent report on the balance of payments pointed out, receipts of dividends and interest on U.S. investment abroad have consistently exceeded new outflows of U.S. capital to foreign countries, with the exception of the 1957–58 period. The Brookings study said that, although earnings primarily reflect investments made in previous years, recent new U.S. investments abroad already seem to be contributing to higher return flows to the United States.

In his message of July 18, 1963, introducing the proposed interest equalization tax, the late President Kennedy pointed out that total U.S. foreign investments amounted to an estimated $72 billion, including approximately $12 billion of relatively low-yield loans extended to foreign governments by the U.S. Government and such agencies as the Export-Import Bank. Of the remaining $60 billion, the so-called direct investments account for approximately $47 billion, while "portfolio investments" are estimated at roughly $12.5 billion. Total 1963 income enjoyed by the United States on account of foreign investments was estimated by the President at $4.3 billion, which is the largest income item on the U.S. balance of payments.

It is, therefore, not surprising that so much criticism is directed at the proposed legislation. While few can argue against the need for effective measures designed to create equilibrium in our balance of payments, many are appalled at the thought that the interest equalization tax is directed against the one type of capital export which contributes more toward a future equilibrium than any segment of our economy.

I would now like to comment briefly about developments here in this country and abroad since last July which I believe call for a reappraisal of the need for the bill at this time.

Since the introduction of this measure there have been several important developments which already have and will continue to have in the future a favorable impact on our balance of payments.

The condition of economic growth in Europe and the relatively slow growth in the United States has been reversed. By the time H.R. 8000 was proposed in July 1963, both the U.S. economy and the U.S. securities markets were outstripping their oversea counterparts. Growing labor cost produced by a shortage of workers and increasing production costs and spiraling prices have produced the familiar profits squeeze in Europe and have slowed growth. American investors also have been taking a much harder look at European companies. Recent financial difficulties experienced by Machines Bull in France and Olivetti in Italy have led to wide concern about the thin capitalization of many foreign companies.

European capital markets have expanded their internal lending activities significantly in recent years, even prior to the introduction of the proposed tax. This is a conclusion reached by a Treasury study entitled, "A Description and Analysis of Certain European Capital Markets," prepared for the Joint Economic Committee in connection with its study last year on the U.S. balance of payments. This expansion has already resulted in increased markets for foreign securities in Europe. According to Secretary Dillon's testimony Monday, sales of foreign securities in European capital markets increased from $200 million during the first half of 1963 to $600 million during the same period in 1964. This expansion has made possible the financing of projects from domestic sources previously financed with capital obtained in the United States.

Since the passage of the tax cut early this year, our investment climate has improved and investment for plant equipment has increased substantially. Such investments were 3 percent higher during the first quarter of 1964 than had been anticipated as late as December 1963. The total of such investments for 1964 is expected to reach $43.9 billion, 10 percent above the fourth quarter of 1963, and 12 percent above 1963 as a whole. In striking comparison, the actual increase in capital spending between 1962 and 1963 was only 5 percent (increasing from $37 to $39 billion. The improved investment climate created by the tax cut has attracted U.S. investment which would have otherwise been invested abroad and may attract additional foreign investment to the United States.

Another factor that must be considered is the substantial expansion of our exports. Between 1962 and 1963, U.S. merchandise exports increased by $1.4 billion, from $20.6 to $21.9 billion compared with an increase of $566 million between 1961 and 1962. During the first quarter of this year, our exports were running at an annual rate of over $24 billion, 21 percent higher than in the first quarter of 1963. It is not very likely that this increase will be sustained throughout the year; nevertheless, such factors as the stability of prices in the United States and continued inflation in Europe and more effective export promotion techniques will be of assistance in maintaining our exports at a high level. On the other hand just such a factor as this interest equalization tax could put a real damper on it.

We must also take into consideration that in contrast to preceding years the gold outflow has declined substantially in 1963—our gold stock declined by $460 million as compared with $900 million in 1962—and during April 1964 our gold stock has actually increased by $178 million.

The most regrettable aspect of this measure is that it is another piecemeal attempt to deal with a problem which is much more fundamental; i.e., the inadequacy of the international monetary system. This system was created in the immediate post World War II period at a time when the major changes which have taken place in the subsequent 16 years were not foreseen. The modernization of that system requires a new look at the adjustment process inherent in the present system and at the manner in which international credit is created by the system. Today it takes years to eliminate major international imbalances unless they are corrected by measures which hamper economic growth and world trade. There is a need for the development of a more flexible adjustment process—in the area of prices, wages, fiscal and monetary policies, interest rates—which permits the speedy restoration of balance-of-payments equilibrium without placing excessive penalties on one or another member of the system. There is also a need to provide for adequate international credit to permit a rapid expansion of international trade and financial transactions.

Today, New York is the preeminent financial market of the world. This is of great economic and political importance. We displaced London as the world's financial center because of the World Wars and the ensuing limitations that Great Britain had to impose upon its capital markets.

If we can help it—and we can—we should not lose our present preeminence to Paris, London, Zurich, or any other financial center.

This bill, coming on the heels of the April 27 report issued by the Fowler committee—the Presidential Task Force on the Balance of Payments—which suggests effective approaches to our balance-of-payments problem on the basis of cooperative steps by Government and private enterprise, may very well confuse our friends overseas. On the one hand, we put barriers in the way of U.S. citizens purchasing foreign securities, while on the other, we propose to pursuade foreigners to buy more U.S. securities.

What about alternatives? Of the several alternatives proposed I would recommend to the committee's attention two possible approaches contained in two amendments I introduced yesterday:

(1) To give to the President, in lieu of the interest equalization tax, standby authority to bring into existence a capital issues committee to regulate the outflow of new securities; (2) should the committee decide to favor the present bill, it should be amended to exempt from the tax any new debt or equity issue of a foreign issuer or obligor if not more than 25 percent of the principal amount of bonds or number of share of the aggregate issue sold are sold to U.S. persons. In addition the Secretary of the Treasury would have discretionary authority to increase or decrease the specified percentage applicable to all issues from time to time, in accordance with the Treasury's view on the U.S. balance of payments.

I am opposed to the tax in its present form. I do not believe that present circumstances call for it. Should a new balance-of-payments emergency arise, however, the Congress should give the President effective authority to deal with this situation. A capital issues committee, composed of representatives of the financial community under the guidance of the Treasury or Federal Reserve Board, could effectively limit the sale of foreign security issues to U.S. citizens, residents, or to domestic corporations, or other entities, public or private.

There is precedent for this amendment in section 708 of the Defense Production Act of 1950, as amended, which resulted in the formation of the Voluntary Credit Restraints Committee during the Korean war period.

There are several advantages to this approach. Such a committee would only be established for the duration of an emergency and could be dismantled at will. That would not be the case with the tax, which would remain in effect at least until the end of 1965 whether needed or not and a law would have to be passed to abolish it before hand.

Finally and very importantly, whereas the interest equalization tax is new and untried—no one has had any experience with it in actual operation—a capital issues committee is a tried and true operation, which has not only been used in this country, but in Switzerland, the United Kingdom, the Netherlands and France as well. It is known and trusted in Western Europe. The Swiss National Bank and the central banks of the United Kingdom, the Netherlands, and France exercise reviewing authority over foreign security issues either alone or jointly with private financial institutions. Therefore, the proposal for a capital issues committee is not a new one. I may add that it has the support of respected members of the financial community in the United States, including the Association of Stock Exchange Firms.

The second alternative is based on a proposal made by Nathaniel Samuels of Kuhn, Loeb & Co. of New York and chairman of the Foreign Investment Committee of the Investment Bankers Association of America. I believe this proposal has a great deal of merit which would make possible the tax free entry into the U.S. capital market of at least a certain percentge of new foreign security issues thereby enbling the U.S. capital market to retain its preeminent position as the world financial center.

In summary, my position is that the proposed bill is not now necessary, and even if an emergency arose, it would be unequal to the task assigned to it. I also believe that there are alternatives available that would be more effective in correcting our imbalance in international payments if a new emergency arose.

The CHAIRMAN. Thank you very much, Senator. The Chair will see that your suggested amendments will come before the committee. Yes, sir?

(The amendments referred to follow:)

[H.R. 8000, 88th Cong., 2d sess.]

[Amendment No. 1094]

AMENDMENT (in the nature of a substitute) Intended to be proposed by Mr. JAVITS to H.R. 8000, an Act to amend the Internal Revenue Code of 1954 to impose a tax on acquisitions of certain foreign securities in order to equalize costs of longer-term financing in the United States and in markets abroad, and for other purposes, viz: Strike out all after the enacting clause and insert in lieu thereof the following:

That (a) the President is authorized to consult with persons in the financial and investment field with a view to encouraging the making by such persons, with the approval of the President, of a voluntary agreement or program limiting the sale of new issues of foreign equity securities or debt obligations to citizens or residents of the United States, or to domestic firms, corporations, or other entities,

public or private. No act or omission to act pursuant to this Act which occurs while this Act is in effect, if requested by the President pursuant to a voluntary agreement or program approved under subsection (a) and found by the President to be in the national interest, shall be construed to be within the prohibitions of the antitrust laws or the Federal Trade Commission Act. A copy of each such request intended to be within the coverage of this section, and any modification or withdrawal thereof, shall be furnished to the Attorney General and the Chairman of the Federal Trade Commission when made, and it shall be published in the Federal Register.

(b) Upon withdrawal of any request or finding made hereunder the provisions of this section shall not apply to any subsequent act or omission to act by reason of such finding or request.

(c) The President may delegate any power or authority conferred upon him by this Act to any officer or agency of the United States; except that in the event such power or authority is delegated to any such officer or agency such officer or agency shall consult with the Attorney General and with the Chairman of the Federal Trade Commission not less than ten days before making any request or finding under this Act, and shall obtain the approval of the Attorney General with respect to any such request before making the same.

(d) This Act and all authority conferred thereunder shall terminate upon the expiration of years after the date of its enactment.

[H.R. 8000, 88th Cong., 2d sess.]

[Amendment No. 1095]

AMENDMENTS Intended to be proposed by Mr. JAVITS to H.R. 8000, an Act to amend the Internal Revenue Code of 1954 to impose a tax on acquisitions of certain foreign securities in order to equalize costs of longer term financing in the United States and in markets abroad, and for other purposes, viz:

On page 51, line 9, insert the following:

"(4) CERTAIN OTHER TRANSACTIONS.—Are acquired by an underwriter in connection with a public offering or private placement by a foreign issuer or obligor provided that not more than 25 percent of the total number of shares of stock or total principal amount of debt obligations sold are sold (including sales by others) to United States persons. The Secretary or his delegate may from time to time by regulation increase or decrease such percentage that may be sold to United States persons, provided that any decrease in the percentage theretofore in effect shall not be effective until 60 days after notice of such decrease is published in the Federal Register. If more than the prescribed percentage then in effect is sold to United States persons the provisions of this subparagraph shall nevertheless be satisfied if a tax equal to 150 percent of the tax imposed by section 4911 is paid on the amount of sales to United States persons in excess of such prescribed percentage. Any tax so paid shall be deemed to be a tax paid under section 4911."

On page 51, line 24, after "persons" insert the following: "or the provisions of paragraph (4) of section 4919 (a) have been satisfied".

On page 51, line 25, after "persons" insert: "or as to the satisfaction of the provisions of paragraph (4) of section 4919(a)".

On page 52, line 6, after "person" insert: "or the provisions of paragraph (4) section 4919(a) were satisfied".

On page 52, line 12, after "persons" insert: "or as to the satisfaction of the provisions of paragraph (4) of section 4919(a)".

Senator BENNETT. No questions.

Mr. Chairman, I have had brought to my attention three problems in connection with this legislation which have not previously been the subject of comments during these hearings. I would like to ask—I would like to submit for the record a statement of the three problems and ask that the staff be authorized to study them in time for consideration at the executive session.

The first problem is concerned with a situation where loans are made with respect to a transaction involving natural resources not

extracted by the U.S. lender but obtained by him in an in-kind exchange transaction for other identical resources extracted by him.

The second problem is concerned with a situation not involving a loan directly by the U.S. person whose natural resources are involved—which may be an exempt transaction under the present bill—but involves a guarantee or other commitment by that person inducing the making of a loan to a non-U.S. person by another U.S. person.

The third problem involves the facility loan provision of the present bill which seems to require that the obligor itself construct the facility with the loan proceeds. It should be made clear in the bill or in the committee report that an affiliate of the obligor can construct the facility.

The CHAIRMAN. Thank you, Senator.

Next witness, Mr. Dan Throop Smith.

Dan, we are glad to welcome you back once more to our committee. You have been here many times, and you have furnished very valuable advice and information.

STATEMENT OF DAN THROOP SMITH, PROFESSOR OF FINANCE, HARVARD GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

Mr. SMITH. Thank you, Senator Byrd. It is always a great pleasure to be here again.

For the record, so that it may be clear, I am here on my own initiative, my own behalf, and at my own expense.

The proposal for the interest equalization tax was an ingenious device intended to produce immediate results at a critical moment in our continuing problems with the balance of payments. A large upward surge in foreign borrowings in 1962 and the first half of 1963 had pushed the adverse balance to a level that could not have been sustained for long.

The attraction of borrowing here was based on lower interest rates than in almost all other countries and, quite apart from cost, on the fact that our financial markets could absorb much larger issues than could be placed in foreign financial markets. The relative importance of these two favorable factors was not clear at the time nor has it yet become clear by hindsight.

During the present uncertainty, while the interest equalization tax is being considered by the Congress, potentially taxable transactions in foreign securities have been virtually suspended. Some resumption of new issues may be expected after the legislation is disposed of in one way or another. To the extent that the breadth of our financial market is more important than our lower interest rates, whatever tax cost is imposed on new bond issues will be absorbed by the borrowers and some new issues will again be made. An adverse effect on our balance of payments may thus be expected by the removal of uncertainty about the extent of the new tax cost, if any.

The proposal as originally made and as adopted in the House went considerably further toward exchange control and selective devaluation of the dollar than was or is necessary. If some legislation is still deemed necessary, the plan before you could be modified to remove most of the flavor of exchange control and devaluation, while still increasing the cost to foreigners of borrowing in our markets. The House Ways and Means Committee improved the bill considerably on

the basis of public hearings and with the collaboration of the Treasury. There has now been time for further reflection on the House bill and, hopefully, additional improvements may be made by this committee.

The improvement in the balance of payments in the past year has been due to several factors. The pressures of cost inflation are, at least momentarily, somewhat stronger abroad than they are here. The terms of wage settlements this summer and fall will have great importance in determining whether we can maintain this very important advantage. In view of the fact that the proposed tax is so completely inconsistent with our basic philosophy of free world capital movements, it is even more to be hoped that this committee will conclude that the tax should not be enacted.

Going on to discuss possible modification, Mr. Chairman, I wish to emphasize that my first and principal point is that the tax should not be enacted at all, even in a modified form. I was delighted to hear Senator Javits use a phrase, I think he said "breaks with tradition." He also referred to elements of exchange control. I wish to associate myself with that sentiment most heartily.

Looking back to the original Presidential message on this, it was I thought disturbing, if I may even use the word. As I read one paragraph of it, I came very close to being heartsick at the interpretation that was put upon the economic situation and the lack of appreciation of the significance of this bill.

Specifically, in the Presidential message, it was stated:

> This Nation will continue to adhere to its historic advocacy of freer trade in capital movements.

I do not see how this bill is consistent with adhering to historic advocacy of freer capital movement.

It was further stated in the same paragraph, "I want to make it equally clear that this Nation will maintain the dollar as good as gold, free interchange with gold at $35 an ounce, the foundation stone of the free world trade and payments system."

It seems to me that this proposal, as I shall indicate, has elements of selective devaluation and exchange control, that various people are being told that their dollars are not freely exchangeable into foreign currencies. The metaphor, the analogy that keeps coming to mind is that of an attempt to cool things off by putting a thermometer in a refrigerator with a glass door and looking at the thermometer and saying things are not as hot as we thought they were.

With those comments on the basic inappropriateness of this legislation, I shall go on to make certain specific proposals for modifications if in the wisdom of this committee it is decided that something in this area is necessary.

If, however, this country is to impose restrictions on capital flows, it appears that this could be done in a less objectionable manner. Briefly, the objective of the proposed tax is to discourage excess foreign reliance on our financial markets by increasing the cost of interest to foreigners on securities sold here. But this would be done not by taxing foreign sellers of securities but by imposing the penalty tax on all U.S. holders of dollars who chose to buy foreign securities, except for those exempted under the act. To be sure, the tax on the U.S. investors will probably be shifted because it will prevent them

from buying foreign securities unless the foreign borrowers will pay enough more to cover the tax. This might be well and good if the only transactions involved were purchases of new issues of securities. The imposition of the tax on the U.S. investors could then be regarded as a more convenient method of imposing a penalty tax on the foreign issuers of securities.

But the tax is not confined to investors in new issues of securities. It is imposed on all purchasers of all securities, new and old, stocks and bonds, except those of the less developed countries. This means that an ordinary individual investor would find that his dollars were at a 15-percent discount if he chose to use them to buy shares in a foreign company, even though the shares had been outstanding for a long time and had not been issued here in the first place, and even though there had been no effort to sell them here at any time. This is the basis for the statement that the tax comes uncomfortably close to a form of selective devaluation of the dollar.

With this tax in its present form, our Government would make the dollars of anyone choosing to spend them to buy foreign stocks worth 15 percent less than the dollars of anyone choosing to use them for any other purpose including the purchase of foreign currencies. In the case of outstanding stock, the burden is entirely on the U.S. purchaser, since the foreign corporation issued the stock in the past and got its full issue price at that time. The U.S. investors are simply told that their dollars are not, for this one purpose, as good as their dollars are for all other purposes. It makes me think back to the multiplicity of exchange rates that were developed in the various countries in the thirties, most notably in Germany.

Symbols may be as important in economic affairs as in politics. They are particularly important in matters involving confidence in the currency. Accordingly, I respectfully urge that the structure of the proposed tax be changed to make it as clear as possible that the intent is not to penalize all U.S. citizens who choose for one reason or another to buy foreign securities as part of a general investment portfolio. Rather, if there is to be a penalty tax, to the extent possible it should be explicitly directed toward the foreign issuer who chooses to take advantage of the cheaper interest and large capacity of our financial markets.

Specifically, since the large and disruptive issues were almost entirely in bonds, foreign stocks should be exempted entirely. Because most individual investors who buy any foreign securities—I emphasize individual investrs—probably buy stocks rather than bonds, the exemption of stocks will remove the symbol, and the stigma, of the indirect exchange control and selective devaluation from all but a few individuals who may be presumed to be highly sophisticated.

The overwhelming importance of bonds in comparison to stock is shown in the exhibits submitted by Secretary Dillon in the House hearings on pages 85 and 86. New issues of bonds taken by U.S. residents were $1,002 million and $945 million in 1962 and the first half of 1963 respectively, while new issues of stock were $74 million and $32 million for the same periods. Net purchases by U.S. residents of outstanding bonds amounted to $29 million and $104 million in the same periods, while in outstanding stocks there were net purchases of $26 million and $2 million. There had been a surge on purchases

of outstanding stock in 1961, amounting to $326 million, but this appears to have been a monetary flurry as the glamor of the European boom reached a climax.

Reduced profit margins and real financial difficulties for some major firms on the Continent have greatly reduced the attraction of investment in stocks of Common Market countries, quite apart from the appearance of the proposed interest equalization tax.

At a time when it is desired to encourage wider foreign holdings of the stock in U.S. corporations, it seems peculiarly inappropriate to take official action to limit purchases of foreign stocks by U.S. investors. That example is not likely to be ignored. I refer specifically to the recommendation of the Fowler committee. I note also that in the original Presidential message on the balance of payments out of which this proposal came, there was a whole section, section 6, devoted to investment by foreign savers in the securities of U.S. private companies, and proposals for changes that needed to be made here and abroad to encourage foreign purchases of U.S. securities. How that very important thing can be reconciled by a proposal to impede U.S. purchases of foreign securities I find it impossible to understand.

Senator BENNETT. Mr. Secretary, it is probably Biblical in its connotation, not to let your right hand know what your left hand is doing.

Mr. SMITH. Thank you, Senator Bennett.

Since it was large new issues of foreign bonds which created the acute squeeze on our balance of payments, one might suggest as a second change in the pending legislation that any tax be confined to these issues and imposed directly on the borrowers for the privilege of tapping our markets for funds. If some tax is to be imposed, the basic tax should be of this sort.

But a practical problem of enforcement is immediately apparent. If the tax were confined to new bond issues in our markets, ways would doubtless develop for the issues to be made abroad and subsequently resold here. Thus, to prevent avoidance, a tax on the sale of existing issues of bonds to U.S. purchasers seems necessary and, as a practical matter, a tax on these transactions can most effectively be imposed on the U.S. purchaser rather than the foreign dollar.

This line of reasoning suggests a dual tax, a basic tax on the foreign issuer of new issues and a complementary tax on the U.S. purchasers of existing issue with, of course, no additional tax on U.S. purchasers who later buy some bonds from those issues on which the tax was paid at the time of its issue by the foreign borrower.

This dual system of tax on foreign issuers and on U.S. purchasers, it may be argued, would be unduly complex. Why not, it may be asked, stick to a single point of impact? Since a tax must be put on the U.S. purchaser of outstanding bonds for enforcement purposes, why not let it fall on the U.S. purchaser in all cases, as is done in the legislation before you.

The answer to this question is not an easy one. A balance must be achieved between symbolism and simplicity. For those particularly concerned to minimize any taint on the free use and convertibility of the dollar, the advantage of having the basic tax on the foreign issuer rather than the U.S. investor is great. The complementary tax on those U.S. investors who buy outstanding issues becomes subordinate. It would be more acceptable psychologically as a necessary enforcement device. The greater complication due to two bases of tax does not

seem excessive. The dual tax would avoid the imposition of a basic tax, in fact an exclusive tax, on U.S. citizens who choose to use their own good, and heretofore freely convertible, dollars for a particular purpose.

One additional modification may be desirable to minimize the burden on our financial intermediaries. If a new issue of dollar bonds were placed abroad by the underwriters to the extent of some large percentage, perhaps 75 or 80 percent, the entire issue might be exempted from the tax. Foreign placement of dollar bonds of foreign issuers is a relatively new procedure, developed in the last decade or so, but it apparently was being developed effectively prior to the proposal for the interest equalization tax. It seems eminently desirable to encourage this form of underwriting on a long-term basis. By giving exemption from a tax on grounds of de minimis for issues largely placed abroad, there could be a strong inducement for underwriters to push ahead immediately in establishing channels and procedures which, once set up, will have longrun advantages to our country.

The minimum fraction of bonds placed here without tax would have an adverse effect on the balance of payments, but for reasons noted at the start of this statement, some resumption of new issues may be expected anyway after the uncertainty about the pending legislation is removed. The differential advantage to the issuer of having the bulk of new issues placed abroad would greatly stimulate underwriters to exert their very best efforts to push ahead on foreign sales.

The immediate advantage for our balance of payments of increased foreign placements of issues which otherwise would have been largely sold here, even with a tax, might well exceed the disadvantage of exemption of the minor fraction which could be sold tax free here. In addition, the foreign profits and the establishment of continuing patterns of foreign placement would improve our balance of payments.

In summary, I urge that purchases of all stocks be exempted from the proposed tax in order to minimize the flavor of exchange control and selective devaluation from this segment of international investment which is in the aggregate relatively unimportant for our balance of payments.

Secondly, I suggest that the basic tax, if this committee is convinced that some tax is necessary, should be imposed on those who borrow through new issues in order to make it clear that our intent is to put the charge on foreigners who choose to take advantage of our broad and relatively cheap financial markets, rather than penalizing U.S. citizens who invest abroad. To complement this tax and prevent its avoidance, a tax would probably also have to be imposed on U.S. purchasers of bonds other than those on which the tax was imposed on the borrowers. The disadvantage of having these two taxes would, I believe, be more than offset by the advantage of lessening the feeling that the dollars of U.S. citizens are being devalued when used for investment purposes abroad.

Finally, I suggest that thought might be given to an exemption from any proposed tax on new issues of dollar bonds when most of them are placed abroad. This could encourage underwriters to develop their placement activities abroad, thereby establishing procedures which would have both immediate and continuing advantages for our balance of payments after any new tax lapses, as hopefully it will very soon.

I just returned to this country from Guatamala for this testimony yesterday, so I had not heard of the previous testimony.

In chatting with Mr. Samuels this morning, I find the last of my three points is somewhat in line with what he proposed yesterday. I understand also it is in line with what Senator Javits proposed as one of his two alternatives. I would like to associate myself with those statements.

I appreciate very greatly the privilege of appearing before this committee, Mr. Chairman. Thank you very much.

The CHAIRMAN. Senator McCarthy?

Senator McCARTHY. Mr. Smith, up to now the only witnesses that have spoken very strongly in favor of the interest equalization tax have been the Treasury. Do you know of any economists or any advisers to the financial community, people in the academic community, who do support the Treasury position on this legislation?

Mr. SMITH. In my conversations I have not found any to the point of identifying them. That is not to say they do not exist.

Senator McCARTHY. None at Harvard who——

Mr. SMITH. Harvard is a large place with a large number of professors. I am sure there is no institutional position on this or any other matter.

Senator McCARTHY. I did not ask you about the institutional position. I asked you if there was anyone at Harvard at the present time or are all of those people who supported this position once at Harvard now in the administration?

Mr. SMITH. Well, my colleague and good friend Stanley Surrey with whom I so frequently disagree on matters of tax policy I assume supports this position.

Senator McCARTHY. I am thinking now of people who are outside of Government.

Mr. SMITH. I am not trying to duck the question, Senator.

Senator McCARTHY. If you do know, because we have not had any testimony really except the Treasury testified in support of the program, and I wondered since you are in the academic community whether there was support among economists who are, say, practicing the science in its pure form or unrelated to Government agencies who support the, if not the program, at least the principle of the interest equalization tax.

Mr. SMITH. In my conversations I do not recall any individuals that I could name, but I am sure there must be some who do support it. I know there have been conversations on the relative merits of this tax and on the Capital Issues Committee. I do not include in my statement any reference to that. I would greatly prefer that, and I think in some conversations with some of my fellow economists there is a feeling if there were to be anything, some sort of a not too formal Capital Issues Committee—moral suasion—might well be effective in this area.

Senator McCARTHY. Is it your opinion that the Treasury perhaps overstates the case for the influence of this as pending legislation upon the balance-of-payments situation?

Mr. SMITH. Well, I think there have been a great many other factors working in our favor in the last 12 or 15 months. I do believe, however, that the pending nature of this bill has had an effect in deterring

34-937—64——17

new foreign issues. As I indicated in my statement, it is my belief that if this bill is regrettably passed, it will be followed by a resumption of foreign borrowings by those who would be willing to pay the tax on new issues. In other words, whether the bill is passed or not, I would anticipate that there would be some resumption of foreign borrowing. However, the amount that would have to be paid in the tax may perhaps turn out to be the difference that leads to a virtual temporary suspension of activities.

Senator McCARTHY. Do you think that same benefit might be secured through the creation of a Capital Issues Committee of some kind?

Mr. SMITH. Oh, I definitely——

Senator McCARTHY. Perhaps you testified to that in your statement.

Mr. SMITH. Yes. It seems to me that is an area where there are a relatively small number of major underwriters who are highly responsible members of the financial community, a Capital Issues Committee of some kind would be most effective. Senator Javits referred in his statement to a precedent, I think in 1950, at the time of the Korean war, when a small number of responsible citizens acted voluntarily to solve a major credit squeeze. I believe moral suasion can be very, very effective.

Senator McCARTHY. I asked the Secretary whether he thought that a Capital Issues Committee perhaps with some jurisdiction over issues in the amount of $100 million or $200 million or more might not be effective, and he expressed the opinion that it would be practically impossible to administer a law which was based upon some cutoff amount or an amount at which jurisdiction begins. Would that be your opinion or would it be——

Mr. SMITH. I see the problem of having an objective test. Take one of the figures you mentioned, $100 million. If the desire was for $150 million, there might be two $75 million issues in sequence. Perhaps that is what the Secretary had in mind. But in all respect, it seems to me a Capital Issues Committee might be developed, might be effective, without a very formal set of objective tests.

I have already twice used the phrase "moral suasion." I will use it again if I may in this connection. I believe that there can be an effective restraint short of legislation in this area by merely getting the representatives of the leading firms together and impressing upon them the importance in the national interests, if it is in the national interest, of holding off for awhile on placements. However, I am not convinced that such action is in the national interest.

Senator McCARTHY. I have no further questions. Thank you very much.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. Just to pick up that idea for one comment, the device of the Capital Issues Committee has the virtue that it is neither official nor public. So that it does not affect the reaction of the American people or the people abroad. The public, the general citizenship of the free countries. Is that an accurate statement?

Mr. SMITH. That, I think, is an accurate statement, and I think it points up the great advantage because the ordinary investors with their

heretofore freely usable dollars would be completely unaffected. There would be no taint upon the currency.

Senator BENNETT. That is all, Mr. Chairman.

The CHAIRMAN. Mr. Smith, I thank you for your very valuable contribution. I hope you will be back before the committee soon again.

Mr. SMITH. Thank you, Senator Byrd.

The CHAIRMAN. Our next witness is Mr. Charles J. Hodge, of Glore, Forgan & Co. of New York, who is appearing in behalf of Tropical Gas Co.

STATEMENT OF CHARLES J. HODGE ON BEHALF OF TROPICAL GAS CO.

Mr. HODGE. My name is Charles J. Hodge. I am a member of the investment banking firm of Glore, Forgan & Co., 45 Wall Street, New York, N.Y. I am also a director, vice president, and chairman of the executive committee of Tropical Gas Co., Inc.

I am appearing on behalf of Tropical Gas Co., Inc., a Panamanian corporation having its principal office at 2151 LeJeune Road, Coral Gables, Miami, Fla., which I shall call "Tropical." Tropical is engaged in the sale of liquified petroleum products in the Caribbean and South America.

I am appearing today to protest the provisions of the act which would exempt from the interest equalization tax acquisitions of a stock of a foreign corporation (where the majority of such stock was owned by U.S. persons) if the principal market for such stock during 1962 was on a national securities exchange in the United States, but not if the principal market of such stock during 1962 was in the over-the-counter market in the United States.

I am also here to protest the fact that the stock of certain foreign corporations conducing more than 80 percent of their business in less developed countries would be exempt from the proposed interest equalization tax, but the stock of certain foreign corporations conducting more than 80 percent of their business in a combination of less developed foreign countries and less developed possessions of the United States would not be exempt from the tax.

STOCK HAVING ITS PRINCIPAL MARKET IN THE UNITED STATES

1. Present language of act: Proposed section 4920(a)(3) (last sentence) of the 1954 Code.

As I understand the act, it is intended to inhibit long-term capital movements out of the United States by imposing a tax on acquisitions of certain foreign securities by U.S. persons. However, the provision of the act which would become the last sentence of section 4920(a)(3) of the Internal Revenue Code of 1954, if the act becomes law, would exempt from the tax any class of stock of a foreign issuer (other than a registered investment company):

> which is traded on one or more national securities exchanges registered with the Securities and Exchange Commission, if the trading on such national securities exchanges constituted the principal market for such class of stock during the calendar year 1962 and if, as of the latest record date before July 19, 1963, more than 50 percent of such class of stock was held of record by United States persons.

In other words, a particular class of stock of a foreign corporation would be exempt from the tax if (i) the principal market for such class of stock during 1962 was on national securities exchanges in the United States and (ii) if more than 50 percent of such class of stock was held of record by U.S. persons on the last record date before July 19, 1963.

2. Tropical's position: No logical distinction can be drawn, for purposes of this tax, between stock traded on a national securities exchange and stock traded in the over-the-counter market.

The stock of Tropical was not listed on a national securities exchange during 1962 and consequently cannot qualify for exemption under the foregoing provision. However, the principal market for Tropical's stock during 1962 was clearly located in the United States, where the stock was actively traded in the over-the-counter market. In fact, as of the latest record date before July 19, 1963, not simply more than 50 percent, but more than 95 percent of the common stock of Tropical was held of record by U.S. persons, and still is owned by such persons.

Three issues of the common stock of Tropical have been registered with the Securities and Exchange Commission, and Tropical is required to report annually to the Commission just like any listed company.

It is Tropical's position that there is absolutely no logical reason for exempting from the interest equalization tax the acquisition of stock of a foreign corporation that was traded on a national securities exchange in the United States during 1962 and had its principal market on such exchange, and not to exempt from the tax the acquisition of stock of a foreign corporation (such as Tropical) that was actively traded in an over-the-counter market in the United States during 1962 and had its principal market on such over-the-counter market.

3. Effect of tax: The tax would damage Tropical and its U.S. shareholders by making it impractical for Tropical (i) to acquire direct ownership of foreign corporations through exchanges of stock and (ii) to compensate foreign employees with stock under stock option and purchase plans.

Tropical is a growing company in a growing industry and is in the process of acquiring other foreign corporations in Central and South America and operating them as subsidiaries. Tropical would prefer to offer its stock to the people who own these foreign corporations, who generally are neither citizens or residents of the United States, in exchange for their stock, rather than to use U.S. dollars to acquire the assets of these foreign corporations, to the detriment of both Tropical's cash position and the U.S. balance-of-payments position. However, Tropical is now being required to pay a premium for the stock of these foreign corporations, when it offers its own stock in exchange, because the sellers believe that the Tropical stock will be subject to the interest equalization tax when they sell such stock to U.S. persons in the United States, where the principal market for such stock is located.

There is still another way in which Tropical would be damaged if its stock were subject to the interest equalization tax. Practically all of Tropical's business is in less developed countries and less developed

possessions of the United States. Much of Tropical's success in these areas has been attributable to the development of a fine staff of local managers. The majority of these managers are not citizens or residents of the United States, but are citizens and residents of the countries in which they are employed. Tropical has offered these employees its stock, under stock option and stock purchase plans, in order to give them a proprietary interest in the company by which they are employed. Obviously, the stock of Tropical is much less attractive to these employees if it will be subject to an intrest equalization tax when they sell such stock to U.S. persons in the United States, where the principal market for such stock is located.

4. Treasury's position: The Treasury states that it is difficult to determine the location of the principal market of a stock which is traded in the over-the-counter market.

On December 23, 1963, Mr. Fred H. Billups, president of Tropical, wrote Senator Smathers calling his attention to the exemption in the last sentence of section 4920(a)(3) and to the fact that this exemption would not extend to the stock of Tropical and other foreign corporations, even though such stock was chiefly owned by U.S. persons and the principal market for such stock was in the United States, if the stock was traded in the over-the-counter market rather than on an exchange. Senator Smathers forwarded this letter to the Treasury Department, and Assistant Secretary Stanley S. Surrey replied in letters dated January 2, 1964, and April 2, 1964. In these letters, Secretary Surrey took the position that it was not possible to identify where the principal market for over-the-counter securities exists, stating:

> The basic difficulty in determining the location of the principal market with respect to over-the-counter companies is that there is no reliable central source of information as to the volume of transactions occurring in the over-the-counter market in different countries, comparable to the exact volume figures maintained by exchanges as to transactions occurring through their facilities. I should also mention that we have received no proposals or suggestions from the National Association of Securities Dealers, the agency which is responsible for regulating trading in the over-the-counter market, as to the method by which the location of the principal market should be determined.

5. Tropical's position: It is not difficult to determine the location of the principal market of a stock which is traded in the over-the-counter market.

It simply is not true that it is difficult to determine the location of the principal market of stock which is traded in the over-the-counter market. Tropical's only transfer agent and registrar are both located in the United States and have complete files on the record ownership of its shares and on all transfers of such record ownership.

A mere glance at the list of stockholders is generally sufficient to establish where the principal market of a security is located. In the case of Tropical's stock, for example, it is perfectly clear that the majority of the stock is held by very small stockholders living on the equivalent of "Main Street" in cities and towns all over the United States. There are, of course, a few stockholders with foreign addresses. The only large blocks of stock, however, are held in "street name" and, of course, Tropical is aware of who these stockholders are. They include Yale University, Beacon Fund, Massachusetts

Institute of Technology, Northwestern Mutual Life Insurance Co., Colonial Fund and so forth.

It is true that stock can always be transferred by endorsement and delivery of the certificates, but this is equally true of stock listed on an exchange as it is stock traded in the over-the-counter market. It is also true that some foreign corporations issue bearer shares, but it would be perfectly simple to deny the exemption to any class of stock represented in whole or in part by bearer shares.

I appreciate that the act before this committee is extremely complex, and that the Treasury is confronted with major problems in administering it. However, if the act is so complex that it cannot fairly achieve its objectives, then it should not be reported favorably by your committee. In the present case, I believe that the objections to the act can be remedied.

6. Suggested amendment: The National Association of Securities Dealers should be permitted to certify, when they deem it appropriate, that the principal market for a particular stock is in the United States.

The problem which Secretary Surrey anticipates in determining the location of the principal market of a stock which is traded in the over-the-counter market can be easily solved. The act already gives cognizance, in proposed section 4918(d), to the existence of "a national securities association registered with the Securities and Exchange Commission," and you have already heard testimony by representatives of such an association, the National Association of Securities Dealers. Obviously, this organization is fully qualified to determine when the principal market for a particular security that is only traded in the over-the-counter market is located in the United States and to certify that fact to the Secretary of the Treasury.

To implement this procedure, the last sentence of the proposed section 4920(a)(3) could be amended to read as follows:

> A foreign corporation (other than a company registered under the Investment Company Act of 1940) *which files reports with the Securities and Exchange Commission pursuant to sections 13 or 15(d) of the Securities Act of 1934* shall not be considered a foreign issuer with respect to any class of its stock which is traded on one or more national securities exchanges registered with the Securities and Exchange Commission *or in any over-the-counter market or markets in the United States*, if the trading on such national securities exchanges *or in such over-the-counter markets* constituted the principal market for such class of stock during the calendar year 1962 and if, as of the latest record date before July 19, 1963, more than 50 percent of such class of stock was held of record by United States persons. *Trading in over-the-counter markets in the United States shall only be deemed to have constituted the principal market for a class of stock during the calendar year 1962 if such fact is certified to the Secretary by a national securities association registered with the Securities and Exchange Commission and if no part of such stock was represented at any time during 1962 by bearer shares.* [New material italicized.]

7. Alternative amendment: The exemption should apply to the stock of a foreign corporation after it has been listed on a national securities exchange, even though it was not listed in 1962, if the principal market for the stock is on such exchange.

Tropical has filed a listing application with the American Stock Exchange and a registration statement with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934. It is anticipated that such listing application will be granted and that trading on such exchange will thereafter constitute the principal market for the stock of Tropical.

If the act is not amended as described above, I respectfully request that it be amended to permit foreign corporations to qualify for the exemption on the basis of facts subsequent to 1962. In this connection, I would emphasize that we are not concerned here with a substantive question of where the principal market of a particular stock is located, but with an evidentiary problem which (the Treasury asserts) can only be met by listing the stock on a national securities exchange.

My proposal would be to amend the last sentence of section 4920(a)(3) to read as follows:

> A foreign corporation (other then a company registered under the Investment Company Act of 1940) shall not be considered a foreign issuer with respect to any class of its stock which is traded on one or more national securities exchanges registered with the Securities and Exchange Commission, if the trading on such national securities exchanges constituted the principal market for such class of stock during the calendar year [1962] *immediately preceding the calendar year in which the acquisition is made* and if, as of the latest record date before July 19, 1963, more than 50 percent of such class of stock was held of record by United States persons." [Deleted material placed in black brackets; new material italicized.]

STOCK OF FOREIGN CORPORATIONS DOING BUSINESS IN LESS-DEVELOPED COUNTRIES AND LESS-DEVELOPED POSSESSIONS OF THE UNITED STATES

1. Acquisitions of stock of "less-developed country corporations" would be exempt from the tax: Proposed section 4916(a)(2) and 4916(b).

Under the provision which would become section 4916(a)(2) of the Code, acquisitions of the stock of a "less-developed country corporation" would be exempt from the interest equalization tax. A less-developed country corporation would be defined in section 4916(c) as a foreign corporation which met either (i) the requirements of section 955(c)(1) or (2) of the Code, which is part of "subpart F" relating to controlled foreign corporations, or (ii) a special test set forth in the act. Under either test, the foreign corporation would be required to establish that 80 percent or more of its gross income was derived from sources within, and 80 percent or more in value of its assets were located in, "less developed countries," with certain adjustments. For purposes of either test, however, the determination of whether a foreign country was a less-developed country would be determined by this act (and not by reference to subpart F).

2. A "less developed country" under the act: Puerto Rico and other possessions of the United States could not be designated as such.

The act would define a "less developed country" in section 4916(b), the pertinent part of which would read as follows:

> (b) LESS DEVELOPED COUNTRY DEFINED.—For purposes of this section, the term "less developed country" means any foreign country (other than an area within the Sino-Soviet bloc) with respect to which * * * there is in effect an Executive order by the President of the United States designating such country as an economically less developed country for purposes of the tax imposed by section 4911. For purposes of the preceding sentence, Executive Order Numbered 11071, dated December 27, 1962 (designating certain areas as economically less developed countries for purposes of subparts A and F of part III of subchapter N, and section 1248 of part IV of subchapter P, of chapter 1), shall be deemed to have been issued and in effect, for purposes of the tax imposed by section 4911, on July 18, 1963, and continuously thereafter until there is in effect the Executive order referred to in the preceding sentence.

3. A "less developed country" under subpart F: Puerto Rico and other possessions of the United States can be designated as such.

Section 955(c)(3) of the code, pursuant to which the foregoing Executive order was published, provides in part as follows:

> (3) LESS DEVELOPED COUNTRY DEFINED.—For purposes of this subpart, the term "less developed country" means (in respect of any foreign corporation) any foreign country (other than an area within the Sino-Soviet bloc) *or any possession of the United States* with respect to which, on the first day of the taxable year, there is in effect an Executive order by the President of the United States designating such country or possession as an economically less developed country for purposes of this subpart. [Italic supplied.]

In Executive Order No. 11071, the President designated the Commonwealth of Puerto Rico and all possessions of the United States as economically less developed countries. I believe it is safe to assume, both from the language of that Executive order and from section 7701(c) of the code, that he did so, in the case of Puerto Rico, on the assumption that Puerto Rico was a possession of the United States, rather than a foreign country.

I take it that you will agree with me that, because of the deliberate omission of the words "or any possession of the United States" in the act before you, the President cannot designate Puerto Rico or any other possession of the United States as a less developed country for purposes of the interest equalization tax.

4. Tropical's position: There is no logical reason for exempting from the tax acquisitions of the stock of corporations doing business in "less developed foreign countries," and not in "less developed possessions of the United States" as well.

If Puerto Rico is regarded as a less developed country, Tropical would appear to have derived 80 percent or more of its gross income from sources within, and had 80 percent or more in value of its assets located in, less developed countries within the meaning of the act. Accordingly, acquisitions of its stock would be exempt from the tax.

Apparently the President regards Puerto Rico as a less developed country or he would not have designated it as such for purposes of subpart F. Accordingly, it seems unreasonably restrictive not to permit him to designate it as such for purposes of the interest equalization tax as well.

5. Suggested amendment: The President should be given authority to designate Puerto Rico and other possessions of the United States as "less developed countries" for purposes of the interest equalization tax.

I respectfully request that the act be amended to insert the words "Puerto Rico or any other possession of the United States" immediately after the words "foreign country (other than an area within the Sino-Soviet bloc)" in section 4916(b).

SUMMARY OF RECOMMENDATIONS

I appreciate the fact that we are dealing with a very complex piece of legislation. Nevertheless, the act is so arbitrary in certain areas that it will operate to the detriment of certain foreign corporations that are principally owned by U.S. persons, and to the detriment of those U.S. persons, without furthering the policy which the act is intended to implement.

For this reason, I have suggested that the act be amended in one of the following three respects:

1. A foreign corporation should not be considered a foreign issuer with respect to any class of stock which is traded in over-the-counter markets in the United States if more than 50 percent of such class of stock is held of record by U.S. persons and a national securities association registered with the Securities and Exchange Commission certifies that trading in such markets constituted the principal market for such class of stock during 1962.

2. A foreign corporation should not be considered a foreign issuer with respect to any class of its stock which is traded on national securities exchanges if more than 50 percent of such class of stock was held of record by U.S. persons and trading on such exchanges constituted the principal market for such class of stock during the calendar year preceding the calendar year of acquisition.

3. The President should be given authority to designate Puerto Rico or any other possession of the United States as a less developed country for purposes of the interest equalization tax, as he has in fact designated them for purposes of "subpart F."

The CHAIRMAN. Thank you for appearing, Mr. Hodge.

Our next witness is Mr. Robert W. Haack of the National Association of Security Dealers.

Proceed, sir.

STATEMENT OF ROBERT W. HAACK, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.; ACCOMPANIED BY H. L. FROY, CHAIRMAN, FOREIGN SECURITIES COMMITTEE; AND MARC A. WHITE, VICE PRESIDENT AND GENERAL COUNSEL

Mr. HAACK. Mr. Chairman and members of the committee, I am Robert W. Haack, president of the National Association of Securities Dealers, Inc. With me are H. L. Froy, chairman of our Foreign Securities Committee, and Marc A. White, vice president and general counsel of the association.

The National Association of Securities Dealers, Inc., which is registered with the Securities and Exchange Commission pursuant to section 15A of the Securities Exchange Act of 1934, is a nationwide organization of approximately 4,000 broker/dealers formed to carry out regulatory functions for the securities industry and to promote just and equitable principles of trade for the protection of the public. My statement sets forth the views of our association regarding the proposed interest equalization tax embodied in H.R. 8000.

Our association is wholly in accord with the administration's objective of taking appropriate steps to eliminate the adverse balance-of-payments problem. In our presentation before the House Ways and Means Committee last August our association indicated its opposition to the enactment of the proposed Interest Equalization Tax Act as being an inappropriate and ineffective solution to this problem. Having made this statement nearly a year ago we now find that developments during the intervening period strongly reinforce the position we took at that time. Without pretending that the balance-of-payments problem has disappeared, we believe that there is even less

reason now than at that time to regard this measure as an appropriate or desirable solution.

The balance-of-payments problem is a highly complicated one and has many facets. To take just one figure for the deficit in payments is quite misleading. The overall payments deficit differs from the deficit on regular transactions; the latter excludes special Government receipts and return of short-term funds to this country. One must keep in mind the important distinction between the private sector, which through its foreign trade and investment activity has returned a rising surplus, and the public sector, which through foreign aid and similar payments had caused a deficit greater than the returns of the private sector.

This bill proposes to remedy the disease by attacking the healthy parts. The role of the U.S. dollar as the free world's key reserve currency rests separately on the free flow of capital across national boundaries. The interruption of this free flow would threaten to jeopardize the standing of the United States in the world's financial markets.

One cannot interfere with the outflow of private capital without immediate repercussions on the quantity and direction of the related inflows. If foreigners have to absorb, as they have for over a year now, large quantities of their own securities sold by U.S. citizens—which by itself produces a surplus of several hundred million dollars a year at present rates—then these foreigners will no longer be able to invest corresponding amounts in U.S. securities.

The July 18 balance-of-payments message by the late President Kennedy contained a number of recommendations intended to bear on this problem. The first requirement was to expand our exports. Here, the private sector has performed magnificently with an increase of $1.2 billion. In recognition of the need to deal with an alarmingly high public sector of the deficit, the message recommended a sharp reduction in the requirements for oversea expenditures. This has not been attained, and the report of the Bank for International Settlements, which has just been released, states that the immediate need is to reduce Government expenditures abroad.

The Secretary of the Treasury, however, continues to propose a measure which, given the uncomfortably high deficit of the first 6 months of 1963, may at that time have recommended itself as at least one of several measures worthy of your consideration. Developments since then, however, tend to underscore the grave doubts that the remedies proposed in the area of private portfolio investment are either practical or appropriate. Nor is there any basis in the statistics available to us so far to indicate that the substantial improvement in the balance of payments since then is in any significant way attributable to the proposal now before you, as a result of its suggested retroactivity.

There are a number of main currents in the complex interrelationship of international payments, besides direct investment, which remain unaffected by the proposed interest equalization tax. The area of portfolio investment breaks down into securities, with their significant differences between debt and equity, on the one hand, and bank loans on the other hand.

Despite its name, the interest equalization tax proposal addresses itself to debt and equity securities alike, even though no one has ever

suggested that foreign stocks have been acquired by Americans for their higher yields. Moreover, there is an important distinction to be made between the placement of new securities flotations in the main, to the extent that they are acquired by domestic residents, and acquisitions of securities issued a long time ago. In fact, there has long been a marked divergence in the pattern of the flow of funds caused by these activities.

By its very nature the function of being banker to the free world implies that a good deal of the capital raised by American underwriters would stem from domestic sources, thus leading to an outflow. If this outflow has, in recent years, given rise to deficits, these must be considered in the longer term framework of an experience in which American investors have been net sellers of foreign dollar bonds for over two decades between 1930 and 1950. Thus, the bulge in recent years has been followed by a return to a more normal relationship consistent with our international responsibilities on the one hand and the increased credit worthiness of foreign borrowers on the other. This experience stands in sharp contrast with the pattern of investment in existing securities, mainly equities, in which a pronounced increase between 1959 and 1961 then gave way to an equally sharp reverse movement which brought back hundreds of millions of dollars to the United States. At the time of the July 18 balance-of-payments measures Americans had been net sellers of these outstanding securities for several calendar quarters. Since the first quarter of 1963, during which American investors still bought about $40 million worth of foreign equities, we have reached an $89 million surplus, representing sales in excess of new purchases in the first quarter of the calendar year.

Of course, there is an obvious and intimate relationship between American portfolio investment abroad and foreign purchases of U.S. securities, both stocks and bonds. In actual fact, for many years foreigners have bought American securities in amounts greatly exceeding the dollar outflow caused by American purchases of foreign securities. Even in the peak year of 1961 when American purchases of foreign equities had reached a record $370 million, foreigners purchased $322,700,000 of domestic stocks from us. If we include foreign purchases of U.S. Government bonds, corporate bonds, and equities during that year we find foreign purchases aggregating $735.7 million compared to total American purchases of foreign securities, both stocks and bonds, of $830.4 million. In other words, in a year marked by record purchases of foreign equity securities by Americans, often at peak prices, the debit of the U.S. balance of payments as a result of international securities transactions between the United States and the rest of the world was only a little less than $100 million, representing 3.2 percent of that year's total deficit of $3.071 billion.

In the course of last year's hearings before the House Ways and Means Committee, it was pointed out that, by concentrating on securities while granting a broad exemption to long-term bank loans, the Treasury had opened up a potentially wide avenue for shifting the outflow from securities purchases to bank loans, thus completely neutralizing the intended effect of this bill. There is now abundant evidence that this prediction has come true. The rise of

new long-term bank loans to foreigners within the categories exempt under the bill which had averaged only $187.45 million between 1951 and 1961, and which had never exceeded the amount of $334,-300,000 shown in 1957, shot up by an unprecendented $815 million last year, the vast bulk of which took place in the second half following the interest equalization tax proposal. For the first 3 months of 1964—the latest data available—the annual rate of outflow rose by about the same amount. In March alone, $115 million of new bank loan money flowed out, net after repayments.

It should be clearly understood that a very considerable proportion of these loans does not in any sense relate to the financing of the export of American-made goods. Quite the contrary can be assumed, since the financing of U.S. exports generally takes the form of credit extended for less than 1 year. At the same time the reduction in holdings of foreign securities and their replacement by a portfolio of long-term credits have not helped the composition of our privately owned assets abroad from the viewpoint of liquidity, since securities can be sold on the market, but bank loans cannot.

On the other hand, the interest equalization tax proposal has had profound effects abroad. Foreign purchases of domestic securities have declined drastically; foreigners, who had consistently been net buyers of American stocks during the last 5 years turned sellers to the tune of $26 million in February and $51 million in March. This stands in sharp contrast to the purpose of point 6 of President Kennedy's balance-of-payments message in which he called for "a direct action program to promote oversea sales of securites of U.S. companies."

To carry out this recommendation, President Kennedy appointed a task force for this specific purpose headed by Mr. Fowler, former Under Secretary of the Treasury. It would be idle to expect recommendations of this kind to be accepted abroad when the administration proposes to curtail its own contributions to the cause of international financial cooperation. This is all the more regrettable since the great success of international cooperation in the field of short-term capital movements has played a signal role in protecting the position of the dollar during the critical years behind us. The administration should not undermine this highly commendable development in the field of long-term finance.

More significantly, the very existence of these proposals has distorted the pattern of international capital flows in a number of ways—all of them prejudicial to the national interest—including the balance of payments itself.

The pending proposal has profoundly disturbed those of our European friends that have been of assistance to us by holding dollars rather than asking for conversion into gold. Nothing can be more prejudicial to these friends' efforts than this proposed patent demonstration that the dollar's universal usefulness is being impaired. That usefulness is fundamental to its continuing functioning as the key reserve currency of the free world. Europeans, with long memories of foreign exchange controls and restrictions on international payments, are extremely sensitive to the implications of this first step.

In conclusion, gentlemen, the National Association of Securities Dealers, Inc., feels that this proposal has outlived its applicability and usefulness under today's circumstances. In 3 months' time

representatives of the free world's financial institutions will meet in Tokyo for the purpose of developing a joint approach to the solution of their individual economic problems through mutual cooperation and not at the expense of each other. In our opinion, it would be a profound mistake for the United States to jeopardize its traditional leadership in this area by unilateral action of the kind proposed here; and accordingly, we believe this legislation should not be enacted.

Thank you.

The CHAIRMAN. Any questions?

Senator MCCARTHY. I have no questions.

Senator BENNETT. No questions.

The CHAIRMAN. Thank you very much, Mr. Haack.

Mr. HAACK. Thank you.

The CHAIRMAN. Our next witness is Mr. I. W. Burnham II, Burnham & Co.

Take a seat, sir, and proceed.

STATEMENT OF I. W. BURNHAM II, SENIOR PARTNER, BURNHAM & CO.; ACCOMPANIED BY ANDRIES D. WOUDHUYSEN, PARTNER

Mr. BURNHAM. Mr. Chairman, members of the committee, I am grateful for the privilege of being able to testify before this committee on the interest equalization tax bill. I have been active in the Nation's financial community for 30 years, and I am founder and senior partner of a firm of stockbrokers and investment bankers which is recognized for its prominence in the international securities business. I am accompanied by Mr. Andries D. Woudhuysen, partner in my firm in charge of the foreign securities business.

The subject before you is an exceedingly complex one, and it is very difficult for any witness to present adequate testimony in the brief time allotted. I will, however, attempt to make my statement as precise and clear as possible.

It will consist of two parts: first, a general critique of the bill, and second, certain specific suggestions for improvement of the bill.

The bill before you is a complex piece of legislation touching on very important aspects of the U.S. economy and its relations with the rest of the world. With the amendments proposed by the Treasury Department the bill is even more complicated. There are a great many problems involved in this measure as is evidenced by the number of witnesses who have asked to appear before this committee in opposition to it. I know that this committee has traditionally exercised great care and thoroughness in dealing with legislation that has come before it. I wish to express the hope that the committee will exercise its customary care and prudence in review and study of the bill.

Indeed, I would recommend very strongly to the committee that there is no urgency attached to the enactment of this legislation in this Congress. The committee, in my opinion, should not hesitate to defer action on it, pending the kind of careful study which the bill deserves. Postponement of final action by the committee on this bill in this session would not be harmful to or inconsistent with the objectives of the administration and the Treasury Department for the following reasons:

First, the bill has been pending since and is retroactive to July 19, 1963. It has been quite effective in eliminating new issues in the United States of foreign securities over the roughly 1 year that the bill has been pending. Indeed, it has been suggested by many—and Secretary Dillon concurs—that it is more effective in its present status than it would be if enacted. If the bill is not enacted this session its effectiveness would not be impaired because it can be reintroduced in the next Congress, and the Treasury Department could announce that it would seek to make the bill retroactive to, say, July 1, 1964. Such an announcement by the Treasury Department of its intention would have the same effect the bill has had for the past year. Nothing therefore would be lost by following this course of action and much would be gained. This committee and the Senate as a whole would have an opportunity to study the bill with the care it deserves. Further experience would be gained for the balance of this calendar year with the U.S. balance-of-payments situation which has shown substantial improvement in the first quarter of 1964. By the time the bill is reintroduced in January 1965, the Congress would have a better basis on which to decide whether legislation in this area is necessary and, if necessary, what form it should take.

Secondly, with further experience the Congress would be in a position to judge whether the bill is fully effective, as well as desirable. I refer particularly to the very substantial growth in commercial bank lending which has taken place since the introduction of the bill and which has had the effect of undoing the major benefits sought by this legislation.

In this connection, I would like to quote from an article in the New York Times for May 3, 1964, entitled "Banks Increase Loans Abroad, but Minimize Interest-Tax Role":

> How much did U.S. banks lend abroad last year? There is some dispute about what the figures really mean.
>
> According to the Department of Commerce, banks lent $1.28 billion (after allowing for repayments), up from $400 million in 1962.

The Journal of Commerce, in a story on the equalization tax bill dated June 17, 1964, noted the following:

> Since the tax was first proposed last July, commercial banks' short-term claims on foreigners have risen by nearly $1 billion.

The approach taken in this bill must be seriously questioned on the grounds of effectiveness, need, and equity. The overwhelming majority of foreign capital transactions in the U.S. balance of payments is not covered by the bill, and some classes of transactions are covered even though they have represented a net inflow of dollars into the United States during the 18 months previous to the announcement of the interest equalization tax, and thus have been helpful to the U.S. balance of payments.

Concerned with the upsurge of investment in new issues of foreign securities (largely foreign-debt securities) in the first half of 1963, the Treasury Department sought the means to reduce such investment through the application of an interest equalization tax. I have no doubt that this tax has been effective over the past year in restraining new issues in the U.S. market. I do entertain serious doubts—evidently shared by Secretary Dillon—that the interest equalization tax will be effective with regard to new issues, once it is enacted. The

Secretary testified last Monday that, with regard to new issues which are the focus of the legislation, there is bound to be an increase in their flotation in the U.S. market once the bill is enacted. How much of an increase will develop cannot, of course, be predicted; but there is no reason to believe that it would be substantial. The size of the U.S. financial market is unparalleled and the facilities it provides for borrowing and equity investment are unmatched. Once the tax is enacted and enters into the calculations of lending and borrowing, there is no question in my mind that there will be a very substantial increase in new foreign issues floated in the U.S. market.

There is thus reason to believe that the present effectiveness of the bill with regard to new issues is not a test of its effectiveness once enacted.

In that respect, the suggestion that a voluntary capital issues committee would be much more effective and infinitely less cumbersome and dangerous, has great merit. What will happen once the proposed interest equalization tax is enacted and foreign borrowers decide to pay the 1 percent annual additional cost on foreign borrowing in the United States, either because the amounts they require are just not available elsewhere or because it is still cheaper to borrow in the United States than in their own country, or because interest rates in other capital markets have increased to the extent that the tax has lost its supposed equalizing power? Is this not what Secretary Dillon meant when he testified last Monday that he did expect the Japanese to be back in our market once the bill is enacted? What, then, is left of the restraining power of the interest equalization tax? Does the committee expect the Treasury to come back to the legislative branch of the Government next year with new proposals to raise the tax rate from 15 percent to 30 percent and perhaps again later, to raise it to 45 percent?

The proposed tax is not effective even with respect to "new issues" once the imaginary differential of 1 percent between interest rates in the United States and abroad has disappeared, whereas a voluntary capital issues committee would be effective under all circumstances. The authority, under the auspices of which the capital issues committee operates, merely has to determine how much money we as a Nation can afford to lend to foreigners from quarter to quarter, and that would be the ceiling, whatever foreigners can afford to pay or are willing to pay in terms of interest rates.

Among my general comments I cannot but raise questions regarding the inequities inherent to the bill. How can the Congress permit legislation which clearly discriminates against the small investor and in favor of the large investor? Is it not true that under the proposed exemption for so-called "direct investments" the Ford Motor Co. would be free from tax to repeat a transaction it did several years ago and spend $390 million to acquire control over a foreign company? Actually, since the announcement of the interest equalization tax on June 18, 1963, there have been such transactions; Minnesota Mining & Chemicals acquired Ferrania, an Italian film-manufacturing company, General Electric acquired an important stake in the French Machine Bull Corp., and Chrysler is on the verge of acquiring a controlling interest in Rootes Motors in England. In this manner, $1,243 million has been permitted to flow out of the United States in the 9-

month period since the interest equalization tax became effective, thus sharply increasing out deficit on the balance of payments.

Do Ford, GE, MMM, and Chrysler pay interest equalization tax? No, they are exempt. But the small investor, the little man, who wants to buy 20 shares of Machine Bull or 50 shares of Rootes, has to pay 15 percent tax. It may seem strange to you for a man in my position to stress this inequity, but I am not only an investment banker but first and foremost an American, and this kind of favoritism just does not seem fair or proper to me.

Ever since I was a child in school I was told that our Government consisted of an executive branch, a legislative branch, and the judiciary.. I cannot quite understand how the legislative branch can permit the executive branch to encroach upon its prerogatives by proposing legislation in a form which has the effect of law without ever having been enacted. This is the first time to my knowledge that this procedure is attempted, and although I perfectly understand the reason which has led to this approach, I wonder, nevertheless, if it should be condoned and be made a precedent for the future. But I am confident that this matter can be judged better by the Members of the Senate with their experience in constitutional law, then by members of the financial community.

As a member of the financial community, prominent in the field of international securities business, we claim expert knowledge on the subject of foreign investment practices and procedures second to none, including hte Treasury Department. In that capacity, I question the need and wisdom of applying the tax to the category "outstanding securities," despite the fact that transactions in outstanding foreign securities have not and are not likely to be a contributing factor to the U.S. balance-of-payments deficit. The plain fact is that for the outstanding securities covered by the bill in its present form—and allowing for redemptions—these made a positive contribution to the U.S. balance of payments since after 1961; that is, a year and a half before the bill went into effect. This has continued since the middle of 1963 and would continue even in the absence of the bill for reasons that are apparent to the committee; namely, that investment in foreign stocks has become much less attractive to American investors as compared with investment in U.S. securities. Despite these factors, the bill is made applicable and effective with rgeard to outstanding secruities—which have not created an outflow of capital– while its effectiveness with regard to new issues is problematic.

The equity and effectiveness of the bill are further brought into question by its limited coverage. The problem of capital movements in the U.S. balance of payments is not confined to new issues and outstanding securities. Direct investment and commercial bank lending are also involved, and yet these are not touched by the bill. While the bill only covers new issues and outstanding securities, there are many exemptions including general ones for Canada, less developed nations, and international institutions. These have to be substracted from the total to get the actual coverage. Subtracting Canada, Latin America, and international institutions alone reduces the scope of the bill to less than 12 percent of total private capital outflow. This raises the question not only of equity but also of effectiveness since, as we

have seen, the exclusion of commercial bank lending has afforded an opportunity for substantial avoidance of the tax.

Senator BENNETT. May I interrupt at this point, Mr. Chairman. Your figure of 12 percent of private capital outflow; in determining the base have you included direct investments?

Mr. BURNHAM. They have been deducted.

Senator BENNETT. I am sorry.

Mr. BURNHAM. They have been deducted.

Senator BENNETT. They are not included, then. The investments like Chrysler and others to which you have been referring are not included in the base on which you figured this 12 percent.

Mr. BURNHAM. Correct.

Senator BENNETT. Thank you.

Mr. BURNHAM. C. Capital Issues Committee a better approach.

We believe that the Treasury Department and the administration should be encouraged to take a broader and more sensible approach to the entire question of capital outflows and their regulation in the light of the needs of the U.S. balance of payments. This will not happen if this bill is enacted before the Senate has an opportunity to carefully examine it and before a reasonable judgment can be arrived at as to its consequences. We would like to voice our support for a proposal advanced in a number of quarters, that the President should be given standby authority to establish a Capital Issues Committee—preferably under the auspices of the New York Federal Reserve Bank—that can act with regard to the entire spectrum of foreign capital transactions by U.S. citizens in the event that the balance-of-payments situation calls for it. This proposal has been supported by a great many people and newspapers, including the New York Times and the Washington Post. We believe such a proposal to be feasible as well as appropriate. There are obviously difficulties and problems in any proposal in so complicated an area, but the Capital Issues Committee approach has the overriding advantage of making it possible to deal with real problems when they arise.

II. SPECIFIC RECOMMENDATIONS

I turn now to certain specific recommendations for improvement of the bill. By advancing these suggestions to the committee, I do not wish to imply that the bill will become a good bill if these suggestions are accepted and that therefore the bill should be enacted in this session of the Congress. All I can say is that if these suggestions are accepted, the bill will be less bad than it is. I would still maintain that no action should be taken on it this year, that further study should be made, and that, hopefully, in such study the proposals I advance would be carefully considered. My proposals are two in number, the first having to do with the treatment of outstanding securities and the second having to do with a matter of smaller scope, namely, trading in equities.

A. Outstanding securities should be excluded from the bill: The bill provides for the application of the tax not only with respect to new issues, but also with regard to transactions in outstanding securities. We submit that covering outstanding securities is not necessary under the bill in terms of balance-of-payments considerations, and that is a punitive measure.

34-937—64——18

As I have already noted, transactions in outstanding securities have not been a problem in the balance of payments of the United States in recent years and promise not to be. Americans have been selling more foreign securities to foreigners than they have been buying from foreigners for some time, and we have every reason to believe that this would continue to be the case even in the absence of the present bill.

Again, as experts in this field, I wish to observe from our own day-to-day experience during the last few years, that perhaps as much as 90 percent of the orders to sell foreign holdings for the account of U.S. investors have had to be executed abroad simply because the United States is not a buyer and has not been a buyer of these securities. And that, notwithstanding the fact that a purchase of these securities by another U.S. person, would have been exempt from the interest equalization tax under section 4918. The strong pressure of U.S. sales of foreign securities abroad is recorded in the New York Times of yesterday, July 1, 1964, about the fact that the improvement in our balance of payments has naturally reflected upon the British balance of payments, and I quote:

> There were two principal reasons for the British financial imbalance: Imports have been much higher than exports, and there has been a net outflow of capital.
>
> Both reasons are indirectly related to the U.S. improvement. Britain's economic recovery from the 1962–63 recession brought heavy foreign purchases, mainly of raw goods that would later be processed into finished goods and sold abroad. The United States is one of Britain's biggest trading partners.
>
> On the capital front, the proposed U.S. interest equalization tax on new foreign securities issues, which has helped stanch the outflow of capital from the United States, has naturally meant a reduction in new American capital invested in Britain.

Since the application of the tax to transactions in outstanding foreign securities is not necessary for balance-of-payments reasons, the tax is merely a punitive measure as far as this class of transactions is concerned. Moreover, it has clear disadvantages for U.S. balance of payments and for American citizens. It means that both the quality and the quantity of American portfolio investments will deteriorate. Since Americans can only sell foreign securities and not buy foreign securities in return, they are unable to change the composition of their portfolios with the result that they cannot take advantage of opportunities which may arise to improve the quality of their portfolios. The result can only be that, over the long term, the inflow of income from abroad on portfolio investment will deteriorate and this again will adversely affect our balance of payments.

We believe that there is no danger attached to the exclusion of outstanding securities from the provisions of this bill. The Treasury Department has argued that there are devious ways in which outstanding securities can be used as a loophole to evade the tax on new issues. We neither understand nor agree with the Treasury Department on this matter. We do not believe that this is possible to begin with, and furthermore, the Treasury seems to overlook some really huge loopholes that exist in the bill and are already being exploited.

We find some merit, however, with another and quite different observation that can be made against the proposal to exempt outstanding securities. As we have indicated, we do not believe that the pattern of net sales by U.S. owners of outstanding foreign securities to foreigners is likely to change, but have to concede that there is a possi-

bility—however unrealistic—that the pattern of net sales could be converted into net purchases with the result that there would be an adverse effect on the U.S. balance of payments on account of transactions in outstanding foreign securities. To meet this problem we advance a compromise solution for which we append a draft amendment. This compromise would simply provide that any American citizen can purchase foreign securities from foreigners free of tax to the extent that U.S.-owned foreign securities are sold to foreigners. Such a reinvestment procedure would make it possible for American citizens to change the composition of their foreign portfolio holdings without the payment of tax. However, if they wish to add to their holdings of foreign securities they would have to pay the tax on any increase in holdings. Under this reinvestment procedure, as we call it, no adverse effects on the U.S. balance of payments can take place since Americans cannot add to their holdings of foreign securities without payment of the tax. This proposal has the clear advantage of permitting Americans to change the composition of their holdings and to protect the flow of income into the United States which is beneficial to the balance of payments. It would permit nearly normal trade in foreign securities to take place and would thus keep the channels of security trading open. This would encourage foreign securities dealers to purchase American securities for their foreign clients, an objective which the U.S. Government seeks very much to promote. Right now we meet with some hostility on the part of our foreign counterparts; we want them to buy our securities, but we cannot buy their securities. We believe that the proposal for a reinvestment procedure is a fair, equitable, and effective compromise solution with regard to the area of outstanding securities that is completely consistent with the objective of the bill, namely, the protection of the U.S. balance of payments. We recommend it most earnestly to the consideration of this committee.

B. Extension to equity securities of 90-day provision of section 4919(a)(3): Under the bill which is before you, a dealer is entitled to a credit or refund of the tax if he acquires foreign debt obligations in the ordinary course of his business and sells them to foreigners within 90 days after their acquisition. We would recommend that this provision be expanded to cover equity securities as well as debt securities. Indeed, we do not understand why the Treasury Department did not recommend such extension since the same principles and the same effects are involved in respect of equity securities as with debt securities. Curiously enough, in the amendments recommended to the Finance Committee by the Treasury Department this section is extended to apply to equity securities but only those sold on the same day on which they were purchased—see discussion on page 30 of the committee print of the Treasury Department's proposed amendments.

The explanation which the Treasury gives of this proposed amendment applies equally to extending the provision for 90 days as in the case of debt obligations. One thing is perfectly clear: if the provision is extended for 90 days there will be no adverse effect on the U.S. balance of payments and indeed one can expect a beneficial effect. Dealers dealing in foreign equity securities do so for the same reason that they deal in foreign debt securities; that is, to make a profit on

the transaction. They could not operate on the basis of a deficit year after year. If they make a profit on a transaction which involves sales to foreigners, it means that there is a greater inflow of funds into the United States and such an inflow is beneficial to the U.S. balance of payments. The provision quite clearly is limited to sales to foreigners; if the securities in question are sold to Americans, the tax is due.

The only comment which the Treasury makes on page 30 of the committee print is that there is a—

> possibility that a broad dealer exclusion in stocks could become a tax-free vehicle for speculation in foreign securities.

I am not quite sure I understand what this means. It strikes me as a highly moralistic observation by the Treasury Department. Is this bill designed to restrict speculation, as the Treasury calls it, or is it designed to help the U.S. balance of payments? What the Treasury describes as "speculation" is described in section 4919(a) (3) as activities "by a dealer in the ordinary course of his business." I cannot understand why the Treasury would be opposed to permitting dealers to undertake transactions in the ordinary course of their business, particularly if such transactions result in an improvement of the U.S. balance of payments. Nor does the Treasury say—and I do not believe they could support such a contention—that applying the 90-day provision in the case of equities would result in adverse effects on the U.S. balance of payments. Unless they can support such a contention, section 4919(a) (3) should be applicable to equities and debt securities alike without any discrimination between the two types of securities. We have talked to a great many of our colleagues in the financial community about this provision of the bill, and we are collectively at a loss to understand the Treasury's position.

Summary: In conclusion, we submit that the bill before you need not and should not be reported by this committee at this session. No harm would come from such delay, and benefits would accrue in terms of providing an opportunity to give this highly technical and complex subject the careful consideration which it deserves in light of developments which have taken place over the last year since the bill has been, as it were, in effect. In the course of the committee's careful deliberation and study of the measure we express the hope that the committee will give close consideration to the proposals which we have advanced.

Thank you for your attention.

The CHAIRMAN. Thank you very much, Mr. Burnham. Any questions? Thank you very much, sir.

(The proposed amendment to H.R. 8000 is as follows:)

Proposed amendment to H.R. 8000 to provide for reinvestment procedure:

"Sec. 4913. Limitation on tax on certain acquisitions

"(c) CREDIT FOR SALES TO NON-UNITED STATES PERSONS—

"If during any calendar quarter a U.S. person acquires stock or debt obligations of a foreign issuer or obligor which would otherwise be subject to tax under the provisions of section 4911, he shall be entitled to a credit against such tax in an amount which shall be computed as follows:

"All sales of stock or debt obligations of foreign issuers or obligors made by him to non-U.S. persons[1] in such calendar quarter shall be segregated. The

[1] The term "non-United States person" should be defined in a separate paragraph which should be inserted between pars. 4 and 5 of sec. 4920 and which should provide simply that the term means any person other than a person described in par. 4.

rates of tax imposed by section 4911 shall then be applied to the proceeds of such sales as though such sales were acquisitions subject to the tax imposed by such section. The total of the amount so computed shall be credited against the tax otherwise payable on acquisitions made by such U.S. person during such calendar quarter; any excess of credit over the tax otherwise payable shall be carried over and applied in subsequent calendar quarters in accordance with regulations prescribed by the Secretary or his delegate."

STATEMENT OF GENE N. WOODFIN, GENERAL PARTNER, CARL M. LOEB, RHOADES & CO.

The CHAIRMAN. The next witness is Mr. Gene N. Woodfin, Carl M. Loeb, Rhoades & Co.

Take a seat, sir, and proceed.

Mr. WOODFIN. Mr. Chairman, I have prepared a written statement which I will not burden this committee by reading. I would ask that it be inserted in the record, but I would like to make a comment or two in th light of what we have had here this morning.

The CHAIRMAN. Without objection, the complete statement will be inserted in the record.

Mr. WOODFIN. Thank you, sir.

This is an extremely complex bit of legislation. At the outset I would like to tell the Chair and the committee that we at Loeb-Rhoades, who are one of the principal and one of the larger brokerage investment banking firms in this country, have been and are now opposed to this tax in the form in which it is submitted or in primarily any other form because we do not think this is the way to get at this matter.

We see here an incredibly complex piece of legislation, and to show you the sort of effect it can have, which I am sure was not intended by the Treasury, I can cite as an example the effect on our London office.

Contrary to Mr. Burnham, who asked you to not do anything on this bill now, I ask you to kill this bill now for the very simple reason that this has been legislation as far as we are concerned since July 18, 1963, and the net effect of that has been demonstrated beyond question with respect to our London operation.

We have an office in London that we have operated for 30 years. We have a resident partner and 33 employees there. It operates in the city as a London financial house.

Since July 18, 1963, when this thing was announced, we have been unable to take positions in London securities and as a consequence, for the first time in 30 years, we have been suffering a loss in that activity.

The very bill here as pronounced in our case has the reverse effect from that intended. Normally we pay all of our London expenses and remit to this country in dollars from $200,000 to $300,000 a year from that office. Since the inception of this bill which prohibits us from trading or taking positions which we must do if we are going to be a part of that community, we have had to remit dollars to London to run this office. So the net effect is an outflow of $500,000 to $600,000 a year in reverse flow of payments.

Now you say how can that come about? How is that possible? Well, it is hard to understand. If we were in any other business but the securities business, we could carry on that business just as we had done before July 18, 1963. Furthermore, if we had carried it on as a foreign partnership, or as a foreign corporation, we could continue

to carry it on with the same effect and with the same profits flowing back to the United States.

Because we operate it as a branch of our partnership, and because of the complexities of the way this bill is drawn, we are foreclosed from being in that business.

Now, this is just one example: There is no telling where this thing goes. This bill is almost as complex as the Revenue Code itself, and this committee knows how long we have wrestled with trying to straighten the Revenue Code out.

Now, where we go and what we do with this thing; as long as it is there, as long as it is proposed with this retroactivity applicable to it, it is just the same as if this bill were passed. It is very difficult, Mr. Chairman, to go to the Treasury Department and get a Treasury ruling on a law that is not yet on the books. You simply cannot operate. We do not send a dime out of the country. We operate on an overdraft or a letter of credit with the London banks, and over the last 10 years we have remitted over a million dollars back to this country. Now, this stopped. The flow goes the other way.

What sense does this make? We asked the Treasury, why this? Well, they say, "You are in the securities business." We say as long as the outflow is the other way, and we would be perfectly willing if we had to send money out to pay the tax on it, but in their technical zeal to cover every possible transaction, you can not have the normal day-to-day commerce in securities even though it results in the inflow of funds and not the outflow.

I say to this committee that if this bill serves any purpose, it has already served the purpose, but I further say to this committee that this thing should be killed. Mature consideration should be given to the thing that caused the outflow; namely, the new issues. I agree with the people who have been here this morning and said that you should omit from this bill anything to do with the existing foreign issues. Nobody is going to put a lot of money in foreign securities. The markets are all down. But we won't get any money here from foreigners to any large extent as long as we have this interest equalization bill. It frightens them. They do not not understand it, and it should be killed now.

If I can answer any questions, I will be very happy to.

The CHAIRMAN. Thank you very much, Mr. Woodfin.

(Mr. Woodfin's statement in full is as follows:)

STATEMENT MADE ON JULY 2, 1964, TO COMMITTEE ON FINANCE OF U.S. SENATE, BY GENE M. WOODFIN, OF AND ON BEHALF OF CARL M. LOEB, RHOADES & CO.

My name is Gene M. Woodfin. I am a general partner in the firm of Carl M. Loeb, Rhoades & Co., whose principal office is at 42 Wall Street, New York City. The firm of Carl M. Loeb, Rhoades & Co. is a member of the New York Stock Exchange, the American Stock Exchange, and of other leading exchanges, and acts as a dealer, broker, underwriter, and investment banker in domestic and foreign securities throughout the world. On behalf of the firm and myself, may I thank the committee for this opportunity to present our views.

My principal purpose in appearing before the committee is to call attention to the failure of the bill to provide exemption for the legitimate pursuit of dealer and trading activities of the bona fide preexisting foreign branches of U.S. partnerships. This void is severely damaging to my firm's London operations; and it is entirely possible that other U.S. partnerships which have foreign branches are similarly affected. Before launching into this phase of my statement, however, I should point out that Carl M. Loeb, Rhoades & Co., feels that

the proposed bill in its entirety is an ill-conceived piece of legislation and that it should be reported on unfavorably by this committee.

The proposed bill in our opinion goes to extreme and unnecessary lengths to legislate with respect to what is but a very minor facet of the broad problem under consideration.

As stated above, the proposed legislation, insofar as it applies in its present form to the oversea activities of my firm, will produce a result which we believe is clearly unintended, and certainly one which is completely contrary to the avowed purpose of the bill. We have pointed this out to representatives of the Treasury Department. They have indicated that they felt ours exemplified a meritorious situation. We were in the process of trying to work out an amendment with them when these hearings were accelerated, resulting in our appearance today.

Our firm has a London office which is not operated as a foreign subsidiary but as a branch of the U.S. firm. This London branch has operated for approximately 30 years and at the present time consists of a resident partner in charge and 33 employees. The business breaks itself down into two major separate and distinct parts. One such phase takes orders from banks, brokers, and institutional and individual investors located in the United Kingdom and Continental Europe, for the purchase and sale of U.S. securities in the U.S. markets, and forwards these orders to New York for execution. During the 4-year period commencing in 1950, this London branch has been responsible for orders placed by foreign persons for the purchase of U.S. securities involving the investment of well over $100 million. The great bulk of this business is the result of many years devoted by the London branch of my firm to the stimulation and development by foreign investors of an interest in the U.S. securities market. The income from this business is realized entirely in dollars in the United States.

Another major phase of the business of our London branch and the one which is disastrously affected by the proposed bill, is the operation for its own account, of a business in foreign securities, acting as a dealer or trader. This phase of our business contributes a great deal to the first phase I have mentioned—it makes us a part of the London financial community and through our daily contacts and dealings in foreign securities we stimulate interest and dealings in U.S. securities. By reason of this business, the London branch has been classified as a United Kingdom resident bank, requiring a United Kingdom license to operate. The profits from this phase of the business have been returned intact for U.S. tax purposes as ordinary income. In the 14-year period commencing in 1950, the net profits from this securities business which have been remitted to the United States have aggregated over $900,000. This is net after payment by the London branch of its own operating expenses out of income generated in foreign currency from these operations. Since the announcement of the proposed interest equalization tax in 1963, this phase of our business has come virtually to a standstill, and as a result our London branch has been operating at a loss, which must be met by remittances of dollars from the United States. We estimate, from the standpoint of flow of dollars, that the enactment of the proposed bill in its present form will produce an adverse result for the United States of somewhere in the neighborhood of $500,000 to $600,000 a year, representing the difference between the historical operational profit of our London branch of somewhere between $200,000 and $300,000 a year, which was consistently generated prior to the announcement of the proposed bill, and the estimated $200,000 to $300,000 a year which the New York office will have to remit to the London branch to pay the operating deficit of that office.

The trading in foreign securities previously done by our London branch represented the conduct of a business and not the placement of funds in foreign securities for investment purposes. The conduct of that business has not required a flow of dollars from the United States. The balances which have been maintained in London have been only those needed for on-going operational expenses. The financial operations themselves have been financed by London bank overdraft in foreign currency under a revolving open line credit arrangement.

Had we operated our London branch as a separate foreign corporate entity, we could under the proposed bill continue our activities in their present form and without being affected in any manner by the operations of the bill. Because we chose (and such choice has operated completely to the advantage of the United States) to transact that business through a branch office, we are seriously and adversely affected.

In our considered judgment the draftsman of the bill was not cognizant of our particular situation or of the reverse action the bill in its present form would produce insofar as the London branch of my firm is concerned.

The profitability of a bona fide securities business should not be destroyed so long as the business is conducted as a branch outside of the United States, in foreign securities and the securities are sold to non-U.S. persons. There should be no greater reason for foreclosing a bona fide securities business of this type from earning dollars for the United States than a business which is concerned with any other kind of property. It is our belief that a bona fide branch operation such as ours, which has been in existence for many years, should be exempt from the interest equalization tax in the same manner as if it had been conducted through a foreign corporation. In our view relief seems particularly appropriate when it is realized that our problem has come into being only because advantages incident to separate foreign legal status were not sought.

We ask that the proposed bill be amended so as to accord to a foreign branch of a U.S. partnership, which has been regularly engaged in the business of dealing in securities outside of the United States for a period of not less than 12 consecutive months prior to July 18, 1963, the same status as a bona fide preexisting foreign corporation.

We are, of course, ready to supply any further information or explanation that this committee may desire and to work with the staff as the committee may desire.

Thank you very much for this opportunity to be heard.

PROPOSED AMENDMENT TO SECTION 4920(a) (5) OF H.R. 8000

There should be added to the existing language of section 4920(a) (5) the following: ", except that such term shall not include a branch office or offices located outside the United States on July 18, 1963, and which has operated for a period of not less than twelve consecutive calendar months prior thereto, where the branch is that of a United States person who is a dealer in securities and all acquisitions by the branch of stock of a foreign issuer or of a debt obligation of a foreign obligor are made by the branch in the ordinary course of its business of dealing in securities, are paid for and sold in foreign currency and are purchased and sold outside the United States."

STATEMENT OF FREDERICK ROE, PARTNER, STEIN ROE & FARNHAM

The CHAIRMAN. Our next witness is Mr. Frederick Roe of Stein Roe & Farnham.

Mr. ROE. Mr. Chairman, Senator Bennett, and Senator McCarthy, my name is Frederick Roe. I am a partner of the investment counsel firm of Stein Roe & Farnham of Chicago and New York. Our firm is neither a banker nor a broker; it specializes in managing the investment portfolios of clients who include individuals, pension funds, profit-sharing plans, charitable organizations, and three mutual funds which bear the name of our firm.

For some time I have taken an active interest in matters pertaining to the balance of payments, and I am a member of the research and policy committee of the Committee for Economic Development. I am also a member of the subcommittees of that organization having to do with fiscal policy and international financial organizations. I do not represent the CED and I mention my affiliation only because I have tried to approach the matter at hand in an objective way in keeping with that organization's traditions.

Senator McCarthy asked my good friend Dan Smith, What were the thoughts of the Harvard professors on the interest equalization bill? I cannot claim that I know all of the thoughts of the Harvard professors, but during the period in which Dan was in Guatemala, a pub-

lication by Harvard University a few weeks ago, "The Review of Economics and Statistics," contained an article by John K. Galbraith, and I would just like to take a minute in answer to Senator McCarthy's question to mention one or two sentences that appear in this article.

Mr. Galbraith says:

> The interest equalization tax was a hurried response to the large capital outflows then taking place * * *. A more effective procedure would be to establish a capital issues committee, authority for which exists, * * * . These are not pleasant measures. However, they are the one coordinate with the task. Past practice has been to deny the need for such measures, sometimes with some firmness and then, as in the case of the interest equalization tax, to resort to them in extremis.

The hour is getting late. There are some portions of my statement which I think are of such importance that I would like to ask your permission to read them in detail. Other portions I am sure I will have your permission to paraphrase.

Senator BENNETT. Will you identify the pages you read so we can follow it?

Mr. ROE. Yes, sir. I shall now begin to read my prepared statement.

The U.S. balance of payments must provide a sufficient surplus on commercial goods and services to finance military expenditures abroad, grants, and credits of the U.S. Government, and private foreign investments. Although the surplus on goods and services has been large in recent years, it has not been as large as the total of these.

In the first half of 1963, the dramatic increase in U.S. purchases of new foreign bonds increased this gap substantially, and created an atmosphere of near crisis which led the Treasury hurriedly to propose the interest equalization tax. Recognizing the seriousness of the problem and fully concurring as to the importance of strengthening the balance-of-payments position of this country, I testified in sympathy with the aims of the Treasury's proposal before the House Ways and Means Committee last August. I did this despite serious reservations as to whether the interest equalization tax approach to the problem provided the necessary flexibility and assured effectiveness. I also urged that the correctives be directed at the source of the problem, new bond issues, and that outstanding foreign common stocks be exempted, on the obvious ground that net purchase of foreign stocks had typically not been large, had dwindled sharply since 1961, and was not expected to become significant in the future.

I would like now to state my position and recommendation.

I continue to believe firmly that, while new foreign bond issues have created problems which we must be prepared to stem, there is no need or justification at this time for applying the proposed tax to outstanding foreign stocks. Having carefully read Secretary Dillon's testimony of last Monday, I must conclude that on this point there is no basic disagreement between us. The Secretary's written statement refers to "new issues of foreign securities" and says repeatedly that the problem relates to "borrowings." The Secretary's testimony is clearly directed at new foreign bond issues and at no point claims that U.S. purchases of outstanding foreign stocks have created balance-of-payments problems.

This defect in the Treasury proposal—namely, that it was framed to include outstanding foreign stocks—was not understandable even in the near-crisis atmosphere of mid-1963. It is even less understandable today; for recent months have seen a substantial basic improvement in our balance-of-payments position, and the prospects for continued improvement seem good. For example, our trade surplus has risen and should benefit in the future from the more rapid increase in employment costs abroad. In the first quarter of 1964, there was a substantial increase in private investment income and further increases can be relied on.

There will remain some risk of change in our balance-of-payments position arising from unanticipated developments. For that reason, I would not deny the need for flexible instruments that might be applied to long-term capital outflows in the period immediately ahead. For example, my first proposal today is that the Treasury be given standby authority to apply the proposed tax to specific areas as necessary. In the case of outstanding foreign stocks, Treasury probably would decide not to apply the tax today, but it would have the authority to do so if needed. This would meet the requirements of prudence without, however, proliferating broad and blunt immediate controls where controls are not needed.

There remains the question of new bond issues, where the size of foreign demand for capital has been obscured by the retroactive feature of the proposed tax. Sharing Secretary Dillon's concern in this matter, and having continued to study the problem of new foreign bond issues since my testimony of last August, I have concluded that in this area, too, a standby interest equalization tax would be useful. In this case, however, it would not be a sufficient instrument. Thus, my second proposal today is that a capital issues committee be established, which would operate under guidelines set by the Treasury as to limits on new foreign borrowing, and which could benefit from a standby interest equalization tax if it were required to confine total demand to the limits established.

Purchases of outstanding foreign stocks have not contributed significantly to our balance-of-payments problem and are not expected to. Except for the single year 1961, U.S. net purchases of outstanding foreign stocks have been completely insignificant over the last several years. Even 1961 could not be taken to represent a problem year, for it was a favorable year in American as well as European stock markets, when purchases of outstanding U.S. stocks by foreign investors likewise reached high levels. Moreover, since that time U.S. transactions in outstanding foreign stocks have become steadily more favorable to our balance-of-payments position. In 1962 U.S. purchases less sales of outstanding foreign stocks contributed negligibly to our overall payments deficit, accounting for less than 1 percent of the total outflow of private U.S. capital. In 1963 these transactions played no part in the outflow of private U.S. capital, and in fact represented an inflow of over $100 million.

The tendency for U.S. sales of outstanding foreign stocks to exceed purchases began before 1963. Specifically, it appears to date from the second quarter of 1962, for in every quarter save one since that time there have been net sales. This conclusion is supported by the small table in the body of my prepared statement, which focuses on

U.S. purchases less sales of outstanding foreign stocks by quarter beginning with 1962. As indicated by the table, in the first quarter of 1962 net purchases amounted to $83 million. Since that time sales have exceeded purchases in every quarter except the second quarter of 1963, when there was an insignificant outflow of $6 million. Thus, not only are we running a payments surplus on account of transactions in outstanding foreign stocks, but this trend was established five quarters prior to the announcement of the interest equalization tax proposal.

The tendency for U.S. sales to exceed purchases no doubt reflects a number of factors, including the influence of the proposed interest equalization tax. From the persistence of the trend prior to announcement of the tax, however, it seems clear that some more fundamental factors have been at work. These factors, which have been favorable to our payments position, are discussed in my prepared statement. They are expected to continue. For example, the study entitled "The United States Balance of Payments in 1968," published last summer by the Brookings Institution, projected that improvements in the U.S. competitive position relative to Europe over the next few years could turn our balance-of-payments deficit into a surplus. In May, the principal author of the study had occasion to reinforce that conclusion in a sort of progress report. He pointed out that—

> of the 8-percent decline in the ratio of United States to Western European GNP prices which we assumed would occur in the 7-year period, apparently about 4 or 5 percent has already occurred in the first 2 years.

After taking factors such as these into account, the Brookings report of last summer foresaw no substantial growth in U.S. purchases of foreign stocks.

One concludes, then, that U.S. transactions in outstanding foreign stocks have not created a payments problem, have in fact for some time tended toward a U.S. surplus position, and seem unlikely to lead to any payments problems in the years ahead. For these reasons, my position is that the proposed interest equalization tax should not be applied to U.S. purchases of outstanding foreign stocks. Application of the tax to such an area sustains the impression that it was hastily conceived and represents an exercise in control for the sheer sake of control.

Now, the issue—and I would like to digress here one minute—goes beyond whether U.S. purchases of foreign stocks should be taxed or not. What is of great importance and involves a matter of broad principle is that controls should not be applied in any area where they are not needed, and I think controls should not be applied any longer than they are needed. I had an extended experience in the War Production Board for 3 years, and I observed in that period the tendency of administrative authorities however good their intentions may be, of extending controls from one area to another simply for the sake of control. I do think that the principle of not extending controls where they are not needed is of great importance.

There are proponents of the interest equalization tax proposal in its present form who agree that outstanding foreign stocks have presented no problem, yet who argue that they must be treated just like new bonds lest investment be merely shifted from one channel into the other. Such an argument seems to be based on an unrealistic

perspective. In the first place, most foreign bond issues are taken up by insurance companies and other U.S. institutional investors who typically do not buy foreign equity securities and in many cases are not permitted to. In the second place, a very large proportion of foreign bond issues come from public and quasi-public bodies, who of course do not issue common stocks. Finally, of course, outstanding stocks cannot be used in any case for new financing.

If the proposed tax is to be applied to foreign stocks, it should be only on a standby basis. And I merely would like to say that the Treasury receives up-to-date information on all movements of capital, and if this trend which has been persistently an inflow in the case of outstanding foreign stocks should ever reverse and become significant in the other direction, Treasury would be well and promptly informed of that change in trend.

In the concluding sections of my prepared statement I point out that, as proposed, the interest equalization tax lacks necessary flexibility when applied to new foreign bond issues, which are the important source of an outflow of portfolio capital. These matters have been discussed by earlier witnesses, and, with your permission, I would like to go forward and make my suggestions that a Capital Issues Committee could provide the flexibility which the proposed tax, in its present form, lacks.

If the tax is passed, and if it proves inadequate by itself to discourage excessive foreign borrowing, then we shall presumably have to supplement it with a more direct measure. It would seem more desirable to establish instruments which can from the outset hold our purchases of new foreign bonds to a reasonable level and which can vary that level flexibility in line with the development of our overall payments position. What seems called for is a Capital Issues Committee, which would operate under guidelines set by the Treasury as to limits on new foreign issues. It is difficult to accept Secretary Dillon's objection of last Monday that a committee of this kind—

> would have to intrude itself directly into the process of individual decisionmaking in a way that this country has never found acceptable save in wartime.

After all, the Treasury has proposed that Canadian new issues be exempt from the tax; and the informal arrangements with Canadian authorities that the Treasury would substitute for the tax must work very much like a Capital Issues Committee. I call your attention to the fact that when the interest equalization tax was first proposed, it was on a Thursday afternoon, and by Sunday morning, the following Sunday, Finance Minister Walter Gordon was in Washington discussing the effect of this tax with the Secretary of the Treasury, and at that point negotiations and control by the two Governments became effective. So the Treasury has had to exercise controls, and the reason I am sure that there have been no further matters of control of this sort in the last 10 months is that the situation has been in a status quo. Once foreign demands for capital again become more prevalent, I am sure that similar negotiations will have to take place not only with our friends in Ottawa but with people from other areas.

Toward the end of my testimony I observe that a standby interest equalization tax could be useful to a Capital Issues Committee. I also point out other features of the Capital Issues Committee, but since Senator Javits has discussed this in detail, I will pass over that portion of my testimony.

In conclusion, I have proposed the creation of a Capital Issues Committee to provide a flexible approach to new foreign bond issues which the interest equalization tax in its present form would lack. I have further proposed that consideration be given to adopting a standby interest equalization tax, both to assist the Capital Issues Committee in its work if that should prove necessary, and to provide a ready means of handling other forms of investment, in the event that they should become troublesome to our balance-of-payments position in the future. Whether or not a Capital Issues Committee is considered feasible, I would urge that outstanding foreign stocks be exempt from application of an interest equalization tax except on a standby basis. This recommendation is based on the fact that U.S. purchases of outstanding foreign stocks have not contributed to our balance-of-payments problem and are not expected to.

Thank you for your kind attention, and I appreciate the opportunity of having appeared today.

The CHAIRMAN. Thank you, Mr. Roe.

Senator MCCARTHY. Mr. Roe, may I ask one question? Do you contemplate that the Capital Issues Committee would have jurisdiction far beyond that which is proposed in the legislation before us in terms of the dates of the issue itself and also geographically?

Mr. ROE. Senator McCarthy, I did not hear your last point.

Senator MCCARTHY. The extent of jurisdiction of the Capital Issues Committee to which you have made reference. Would it have broader authority than is contemplated——

Mr. ROE. I think it should have authority to touch all forms of exported capital.

Senator MCCARTHY. In all areas of the world?

Mr. ROE. Oh, yes.

Senator MCCARTHY. Canadian——

Mr. ROE. Oh, yes.

Senator MCCARTHY. Latin America?

Mr. ROE. Yes, sir. Both in areas of the world and in forms of capital. These are hard problems, and no one wants to enter into things like a Capital Issues Committee, but our balance of payments is an important issue, and the position of the dollar is of paramount importance. I think we should do what we have to do, but we should not do any more than we have to do, and I think we should keep a flexible approach.

Senator MCCARTHY. You suggested it might also have jurisdiction over transactions such as those of Ford and Chrysler to which reference has been made even though they are not quite in the securities field.

Mr. ROE. You are talking about—I think someone referred here to the purchase of an interest by American corporations of outstanding issues abroad, and under the present act whatever is purchased by one who owns more than 10 percent of the outstanding stock is considered direct investment. Yes, sir.

Senator MCCARTHY. You stated there should be some kind of authority over that type of transaction as well.

Mr. ROE. Yes, sir.

Senator MCCARTHY. Thank you.

Senator BENNETT. Just one question. It has been made obvious to the committee that the increase in bank loans has offset any reduction in new capital issues. Would you extend the authority of this committee to major bank loans?

Mr. ROE. Yes; I would.

Senator BENNETT. Thank you.

The CHAIRMAN. Thank you, Mr. Roe.

(The following letter of explanation was subsequently submitted by Mr. Roe:)

JULY 9, 1964.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: Upon reading the transcript of my testimony on H.R. 8000, it has occurred to me that my answer to Senator McCarthy's question concerning direct investment might be misunderstood. As stated in my testimony, it is *new bond issues* that were a demonstrated cause of our payments problem last year, and it is to this area—not to direct investment—that the Treasury's interest equalization tax proposal and my own proposal for a Capital Issues Committee have been directed. The Capital Issues Committee would not normally be involved in any way with direct investment, except that it could provide an informal framework for consultation in this area as in the area of bank loans. However, the position of the dollar is of paramount importance, as I stated. I consequently believe that our attitude should be flexible, and that Congress should be prepared to extend the application of control to direct investment or any other form of private long-term capital movement if a demonstrated need should arise. It is in this context that I would wish my answer to Senator McCarthy's question to be understood.

I should appreciate your inserting these comments into the record, after the questions which followed my oral testimony.

Sincerely,

FREDERICK ROE.

Senator DOUGLAS. Mr. Chairman, first, may I express my regret to Mr. Roe that because we were marking up the housing bill, I was unable to get in in time to hear the major portion of his testimony.

I would like to say for the benefit of the committee that Mr. Roe and the firm of which he is a member have the highest reputation in Chicago as investment counselors and managers. He started three mutual funds. They do this with great integrity and skill, and his testimony should be taken very seriously.

Just one question I would like to ask and that is what type of a Capital Issues Committee he would suggest? What public power should it have, and how should it be composed?

Mr. ROE. I am sure that the authority to approve or disapprove the issuance of securities should not be given to a private person.

Senator DOUGLAS. Should not?

Mr. ROE. No. I think there should be a consultative body possibly. I am sure that the people on the Federal Reserve Board, Federal Reserve Bank of New York, and the Treasury in some manner should be the people who approve both the amount and, if it is necessary, the specific issues. I am sure everybody wants to avoid that last point. That is very important. But I am sure that the final authority must rest with the Government.

Senator DOUGLAS. Who would appoint the Capital Issues Committee, the Secretary of the Treasury?

Mr. ROE. That would be I think a reasonable approach.

Senator DOUGLAS. Thank you very much.

Mr. ROE. Thank you, gentlemen.

(Mr. Roe's statement in full is as follows.)

STATEMENT OF FREDERICK ROE, OF STEIN ROE & FARNHAM, ON JULY 2, 1964

Introduction

My name is Frederick Roe. I am a partner of the investment counsel firm of Stein Roe & Farnham of Chicago and New York. Our firm is neither a banker nor a broker; it specializes in managing the investment portfolios of clients who include individuals, pension funds, profit-sharing plans, charitable organizations, and three mutual funds which bear the name of our firm. The mutual funds which we manage are no-load funds and have approximately 14,000 shareholders in the aggregate. They represent a significant but not a major portion of our business.

For some time I have taken an active interest in matters pertaining to the balance of payments, and I am a member of the Research and Policy Committee of the Committee for Economic Development. I do not represent the CED and I mention my affiliation only because I have tried to approach the matter at hand in an objective way in keeping with that organization's traditions.

The U.S. balance of payments must provide a sufficient surplus on commercial goods and services to finance military expenditures abroad, grants and credits of the U.S. Government, and private foreign investments. Although the surplus on goods and services has been large in recent years, it has not been as large as the total of these.

In the first half of 1963, the dramatic increase in U.S. purchases of new foreign bonds increased this gap substantially, and created an atmosphere of near crisis which led the Treasury hurriedly to propose the interest equalization tax. Recognizing the seriousness of the problem and fully concurring as to the importance of strengthening the balance-of-payments position of this country, I testified in sympathy with the aims of the Treasury's proposal before the House Ways and Means Committee last August. I did this despite serious reservations as to whether the interest equalization tax approach to the problem provided the necessary flexibility and assured effectiveness. I also urged that the correctives be directed at the source of the problem, new bond issues, and that outstanding foreign common stocks be exempted, on the obvious ground that net purchase of foreign stocks had typically not been large, had dwindled sharply since 1961, and was not expected to become significant in the future.

Statement of position and recommendations

I continue to believe firmly that, while new foreign bond issues have created problems which we must be prepared to stem, there is no need or justification at this time for applying the proposed tax to outstanding foreign stocks. Having carefully read Secretary Dillon's testimony of last Monday, I must conclude that on this point there is no basic disagreement between us. The Secretary's written statement refers to "new issues of foregin securities" and says repeatedly that the problem relates to "borrowings." The Secretary's testimony is clearly directed at new foreign bond issues and at no point claims that U.S. purchases of outstanding foreign stocks have created balance-of-payments problems.

This defect in the Treasury proposal—namely, that it was framed to include outstanding stocks—was not understandable even in the near-crisis atmosphere of mid-1963. It is even less understandable today; for recent months have been a substantial basic improvement in our balance-of-payment position, and the prospects for continued improvement seem good. For example, our trade surplus has risen and should benefit in the future from the more rapid increase in employment costs abroad. In the first quarter of 1964 there was a substantial rise in private investment income and further increases can be relied on.

There will remain some risk of change in our payments position arising from unanticipated developments. For that reason, I would not deny the need for flexible instruments that might be applied to long-term capital outflows in the period immediately ahead. For example, my first proposal today is that the Treasury be given standby authority to apply the proposed tax to specific areas as necessary. In the case of outstanding foreign stocks, Treasury probably would decide not to apply the tax today, but it would have the authority to do so if needed. This would meet the requirements of prudence without, however, proliferating broad and blunt immediate controls where controls are not needed.

There remains the question of new bond issues, where the size of foreign demand for capital has been obscured by the retroactive feature of the proposed

tax. Sharing Secretary Dillon's concern in this matter, and having continued to study the problem of new foreign bond issues since my testimony of last August, I have concluded that in this area too a standby interest equalization tax would be useful. In this case, however, it would not be a sufficient instrument. Thus, my second proposal today is that a Capital Issues Committee be established, which would operate under guidelines set by the Treasury as to limits on new foreign borrowing, and which could benefit from a standby interest equalization tax if it were required to confine total demand to the limits established.

Purchases of outstanding foreign stocks have not contributed significantly to our balance-of-payments problem and are not expected to

Except for the single year 1961, U.S. net purchases of outstanding foreign stocks have been completely insignificant over the last several years. Even 1961 could not be taken to represent a problem year, for it was a favorable year in American as well as European stock markets, when purchases of outstanding U.S. stocks by foreign investors likewise reached high levels. Moreover, since that time U.S. transactions in outstanding foreign stocks have become steadily more favorable to our balance-of-payments position. In 1962, U.S. purchases less sales of outstanding foreign stocks contributed negligibly to our overall payments deficit, accounting for less than 1 percent of the total outflow of private U.S. capital. In 1963, these transactions played no part in the outflow of private U.S. capital, and in fact represented an inflow of over $100 million.

The tendency for U.S. sales of outstanding foreign stocks to exceed purchases began before 1963. Specifically, it appears to date from the second quarter of 1962, for in every quarter save one since that time there have been net sales. This conclusion is supported by the following table, which comes from Commerce Department data.

U.S. purchases less sales of outstanding foreign stocks, 1962–64, by quarter

[(—) denotes net purchases in millions of dollars]

1962					1963					1964
1st quarter	2d quarter	3d quarter	4th quarter	Year	1st quarter	2d quarter	3d quarter	4th quarter	Year	1st quarter
−83	+7	+2	+48	−26	+8	−6	+17	+99	+113	+90

Thus, not only are we running a payments surplus on account of transactions in outstanding foreign stocks, but this trend was established five quarters prior to the announcement of the interest equalization tax proposal.

The tendency for U.S. sales to exceed purchases no doubt reflects a number of factors, including the influence of the proposed interest equalization tax. From the persistence of the trend prior to announcement of the tax, however, it seems clear that some more fundamental factors have been at work. For one thing, European share prices moved up sharply in the stock market boom of 1961, and many Americans who bought at that time have subsequently sold out of disaffection. Over the same time period, American commentators have emphasized that supply limitations would prevent Europe's long-term growth rate from matching that of the postwar boom years; and, more recently, they have placed stress on the increasingly attractive prospective U.S. growth rate and on the relatively more rapid pace of cost inflation in Europe.

You are familiar with the analyses which project a continuation, well into the future, of the conditions just described. For example, the study entitled "The United States Balance of Payments in 1968," published last summer by the Brookings Institution, projected that improvements in the U.S. competitive position relative to Europe over the next few years could turn our balance-of-payments deficit into a surplus. Last month the principal author of the study had occasion to reinforce that conclusion in a sort of progress report. He pointed out that "of the 8 percent decline in the ratio of United States to Western European GNP prices which we assumed would occur in the 7-year period, apparently about 4 or 5 percent has already occurred in the first 2 years." After taking factors such as these into account, the Brookings report of last summer foresaw no substantial growth in U.S. purchases of foreign stocks.

One concludes, then, that U.S. transactions in outstanding foreign stocks have not created a payments problem, have in fact for some time tended toward a U.S. surplus position, and seem unlikely to lead to any payments problems in the years ahead. For these reasons, my position is that the proposed interest equalization tax should not be applied to U.S. purchases of outstanding foreign stocks. Application of the tax to such an area sustains the impression that it was hastily conceived and represents an exercise in control for the sheer sake of control.

There are proponents of the interest equalization tax proposal in its present form who agree that outstanding foreign stocks have presented no problem, yet who argue that they must be treated just like new bonds lest investment be merely shifted from one channel into the other. Such an argument seems to be based on an unrealistic perspective. In the first place, most foreign bond issues are taken up by insurance companies and other U.S. institutional investors who typically do not buy foreign equity securities and in many cases are not permitted to. In the second place, a very large proportion of foreign bond issues come from public and quasi-public bodies, who of course do not issue common stocks. Finally, of course, outstanding stocks cannot be used in any case for new financing.

If the proposed tax is applied to outstanding foreign stocks, it should be only on a standby basis

It is true that there can always be surprises—turns for the worse—in the future, and one must be prepared to meet them. This leads to my proposal: that the Treasury be given authority on a standby basis to apply an interest equalization tax of the sort now under consideration to any area of investment where the conditions at the time may warrant. This would give the proposed tax a flexibility which it now lacks; for it would provide a readily available instrument for use in areas like outstanding foreign stocks where the actual imposition of the tax at this time is unnecessary. The Treasury, which receives up-to-date information on American buying of outstanding stocks, could move in this area promptly if the need arose.

As proposed, the interest equalization tax lacks necessary flexibility when applied to new foreign body issues

Since the interest equalization tax was proposed, there has been a considerable decline in new issues of foreign bonds. For example, U.S. purchases of new foreign bonds were $131 million in the first quarter of 1964, as against $481 million in the first quarter of last year, $511 million in the second quarter, and a 1963 quartely average of $310 million.

It would be tempting to conclude that this reduction gives a measure of the possible continuing effectivness of the proposed tax. Such a conclusion is tenuous. In the first place, as the proposed tax is retroactive it has had an inhibiting effect on borrowers and investors. If the tax is enacted, both will know where they stand, the tax will be obsorbed partly by one and partly by the other, and new issues of foreign bonds could rise substantially. In the second place, a reduction in new issues of foreign bonds does not result in an equal reduction in U.S. private capital ouflow. As bank loans up to 3 years are exempt from the proposed tax, there appears to have been a sizable shift to bank borrowings on the part of debtors who formerly would have financed by bond offerings. The net outflow of funds for long-term loans by institutions rose from a $73 million quarterly average in the first half of 1963 to a $209 million quarterly rate in the second half and to $232 million in the first quarter of the current year.

The proposed tax could not readily be extended to bank lending—thereby preventing tax avoidance—without running the risk of disrupting production and trade. The proposed instrument is peculiarly inflexible. And yet, flexibility will almost surely be required, for it cannot be demonstrated that a theoretical 1-percent increase in the cost of borrowing will restrict foreign new issue activity to the "right" level. First, there is the question whether the 1 percent properly measures the exising differential allowing for the higher cost of issuing securities abroad. Second, there is the question of the movement of the longer term interest rate in Europe given the present more inflationary trends there. Third, perhaps more important than the lower U.S. interest rate as such is the broadness of the U.S. market, which can absorb large new issues, and the comparative narrowness of foreign capital markets. It is true that the Western European countries are improving their institutional facilities for handling internal and foreign bond issues. However, until this process is more advanced, and the costs of issuing securities in Europe considerably re-

34-937—64——19

duced, diversion of foreign long-term borrowing from this country to the European surplus countries, on a continuing basis, all will necessarily be quite limited.

A Capital Issues Committee could provide the flexibility which the proposed tax, in its present form, lacks

If the tax is passed, and if—for the above reasons—it proves inadequate by itself to discourage excessive foreign borrowing, then we shall presumably have to supplement it with a more direct measure. It would seem more desirable to establish instruments which can from the outset hold our purchases of new foreign bonds to a reasonable level and which can vary that level flexibly in line with the development of our overall payments position. What seems called for is a Capital Issues Committee, which would operate under guidelines set by the Treasury as to limits on new foreign issues. It is difficult to accept Secretary Dillon's objection of last Monday that a committee of this kind "would have to intrude itself directly into the process of individual decisionmaking in a way that this country has never found acceptable save in wartime." After all, the Treasury has proposed that Canadian new issues be exempt from the tax; and the informal arrangements with Canadian authorities that the Treasury would substitute for the tax must work very much like a Capital Issues Committee. If such arrangements can be made to work with Canada, which accounted for almost two-thirds of foreign new issues in the United States in the critical first half of 1963, it is difficult to understand why they cannot be made to work with other countries. In order to emphasize this point that Canada has made far larger new capital issues in the United States than has any other country, I am attaching to my testimony as table II a table originally presented by Secretary Dillon in his testimony of last Monday.

Unlike the proposed tax by itself, a program involving a Capital Issues Committee could limit new issues in a predictable manner. Moreover, levels of permitted borrowing could be projected into the future, permitting orderly scheduling. The committee might also act as a consultative body, which could work on an informal basis with the Federal Reserve to help insure that bank lending does not damage the effectiveness of new issue limitation. It could also coordinate with agencies in other countries to encourage more foreign long-term borrowing in their markets. Germany, with its present efforts to stimulate greater capital export, is the principal example of such a country.

Again, a standby interest equalization tax could be useful

If the proposed Capital Issues Committee is set up, it might be useful to adopt an interest equalization tax on a standby basis to reinforce the Committee, in case the demand for capital is significantly in excess of the Treasury guidelines and the excess cannot be readily deferred through a scheduling arrangement. As suggested earlier, the basic difficulty of relying on the tax alone is that it seems incapable of ensuring an overall rate of foreign borrowing that is "right" with respect both to our national aims and to the changing constraint of our overall balance-of-payments position. However, on a standby basis, the tax would be available for use if required in helping the Treasury and the Committee to confine total demand to the limits established. This would be in addition to the use of the standby tax in the unlikely event that significant capital outflows occur on account of outstanding foreign stocks.

Conclusion

I have proposed the creation of a capital issues committee to provide a flexible approach to new foreign bond issues which the interest equalization tax in its present form would lack. I have further proposed that consideration be given to adopting a standby interest equalization tax, both to assist the Capital Issues Committee in its work if that should prove necessary, and to provide a ready means of handling other forms of investment, in the event that they should become troublesome to our balance-of-payments position in the future. Whether or not a capital issues committee is considered feasible, I would urge that outstanding foreign stocks be exempt from application of an interest equalization tax except on a standby basis. This recommendation is based on the fact that U.S. purchases of outstanding foreign stocks have not contributed to our balance-of-payments problem and are not expected to.

Thank you for your kind attention. I have appreciated the opportunity of testifying today, and I wish you success in the continuing work of your committee.

TABLE I.—*Movement of private U.S. capital, 1960 through 1st quarter 1964*

[(—) denotes outflow in millions of dollars]

	1960	1961	1962	1963	Unadjusted seasonally 1963 1st quarter	1963 2d quarter	1963 3rd quarter	1963 4th quarter	1964 1st quarter
1. Direct foreign investment, net	−$1,674	−$1,599	−$1,654	−$1,862	−$551	−$501	−$136	−$674	−$433
2. Short-term capital, net	−1,348	−1,556	−553	−696	+61	−532	+121	−346	−630
3. Long-term foreign loans by institutions	−200	−263	−258	−564	−19	−127	−113	−305	−232
4. New foreign bonds	−541	−487	−1,002	−1,241	−481	−511	−163	−86	−131
5. Outstanding foreign bonds	−234	−61	−70	−119	−62	−62	+15	−10	+9
6. New foreign stocks	−14	−36	−74	−53	−25	−7	−21	0	−1
7. Outstanding foreign stocks	−75	−326	−26	+113	+3	−6	+17	+99	+90
Total	−4,086	−4,328	−3,637	−4,422	−1,074	−1,746	−280	−1,322	−1,328
Redemptions of U.S. held foreign bonds	+201	+148	+203	+195	+43	+50	+52	+50	+44
Total, after redemptions	−3,885	−4,180	−3,434	−4,227	−1,031	−1,696	−228	−1,272	−1,284

Source: U.S. Department of Commerce.

TABLE II.—*New issues of foreign securities purchased by U.S. residents by area 1960 through 1st quarter 1964*

[Table originally submitted by Secretary Dillon on June 29, 1964]

[In millions of dollars]

	1960	1961	1962	1963 1st half	1963 2d half	1963 Total	1964 1st quarter
Canada	221	237	457	632	105	737	91
Western Europe	24	57	195	219	53	272	-------
Japan	15	61	101	83	57	140	-------
Other developed [1]	27	43	60	17	-------	17	-------
Latin American Republics	107	18	[2] 102	13	23	36	13
Other less developed	64	95	77	35	32	67	24
International institutions	97	12	84	-------	-------	-------	4
Total new issues	555	523	1,076	[3] 999	270	[3] 1,269	132

[1] Australia, New Zealand, South Africa.
[2] Includes $75,000,000 issues by Inter-American Development Bank.
[3] Mr. Roe's note: Understated by $25,000,000, apparently due to Japanese issue. For all other periods, totals reconcile with table I, above.

Source: Survey of Current Business and Department of Commerce.

The CHAIRMAN. The next witness is Mr. Harry L. Freeman. Have a seat, Mr. Freeman.

STATEMENT OF HARRY L. FREEMAN, OF JANIN, MORGAN, BRENNER & FREEMAN

Mr. FREEMAN. Thank you, Mr. Chairman. My name is Harry Freeman, member of the law firm of Janin, Morgan, Brenner & Freeman in San Francisco. My statement will be very brief, Mr. Chairman. I have a very narrow point to make but an important point.

We represent a group of U.S. citizens who are residing abroad as employees of foreign companies, principally Canadian. The purpose of my testimony today is to secure an amendment to the bill as passed by the House in the area of employee stock options. The House bill now exempts the issuance, which is to say the grant, of stock options to employees. The bill also exempts the exercise, that is to say, the purchase of stock options, of securities, pursuant to the grant of an option which was outstanding the day the administration proposed the tax on July 18, 1963.

We submit there should be an exemption of exercises of employees' stock options by bona fide foreign residents, whether or not the options existed on July 18, 1963.

In substance, the amendment we seek would apply prospectively to the exercise of stock options but only to the rather limited group of U.S. citizens who are bona fide foreign residents.

The House bill treats stock options in a very special way. It would not—the bill as passed by the House would not apply at the time of the grant of an option to an employee and would not apply to an exercise of an option if the option was held on July 18, 1963. But the House bill does not cover the exercise of employee stock options granted after July 18, 1963.

This is not a request for a general exemption of all exercises of all employees' stock options but rather an exemption only for such exercises by U.S. citizens having established a bona fide foreign residence

which is a specifically defined term in the existing Internal Revenue Code.

Probably the most common example of such an individual is the U.S. citizen employed on an indefinite basis by a foreign company. The reason for the limitation is that bona fide foreign residents are typically compensated with foreign funds and deposit their income in foreign banks, and therefore their income does not usually enter the mainstream of the American economy, and hence affect the dollar inflow or outflow.

The source of funds to exercise such stock options typically would be derived from the same foreign banks. Hence, there is no large outflow of dollars in the exercise of these employees' stock options.

The effect of the proposed tax as presently passed by the House would be to inhibit the exercise of newly granted options or options granted in the future. It would probably also inhibit the granting of new options to U.S. citizens.

It is submitted that the proposed tax is not meant to cover such situations since the transactions would have little or no effect on our balance of payments. Although reasonable arguments can be made for complete exemption of the employees' stock options, we are only requesting a limited exemption.

My further comments are in the statement which I ask leave to submit, Mr. Chairman.

The CHAIRMAN. Thank you very much. Your statement will be printed in full in the record.

Mr. FREEMAN. Thank you.

(Mr. Freeman's statement in full is as follows:)

STATEMENT OF HARRY L. FREEMAN, ATTORNEY AT LAW

This statement is made by Harry L. Freeman, attorney at law, of the law firm of Janin, Morgan, Brenner & Freemen, San Francisco, Calif, on behalf of a group of clients who are U.S. citizens residing abroad as employees of foreign companies, principally Canadian.

The purpose of this testimony is to secure an amendment to the bill, as passed by the House, in the area of employee stock options.

The House bill now exempts the issuance, or grant, of stock options which, for all practical purposes, would cover those granted in the normal course of business, whether or not prior to the Revenue Act of 1964. The bill also exempts the exercise, i.e., the purchase, of securities pursuant to the grant of an option which was outstanding on July 18, 1963.

It is submitted that there should be an exemption of exercises of options by bona fide foreign residents whether or not the options existed on July 18, 1963. In substance, the amendment requested would apply prospectively to the exercise of stock options, but only to the rather limited group of bona fide foreign residents.

The bill, as passed by the House, treats stock options as follows:

1. The tax will not apply at the time of the grant of an option to an employee. Section 4914(a) provides as follows:

"TRANSACTIONS NOT CONSIDERED ACQUISITIONS.—The term 'acquisitions' shall not include—

* * * * * * *

> "(7) the grant of a stock option or similar right to a United States person who is an individual, for any reason connected with his employment by a corporation, if such option or right (A) is granted by the employer corporation, or its parent or subsidiary corporation, to purchase stock of any such corporations, and (B) by its terms is not transferable by such United States person otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him."

2. The tax will not apply to an exercise of an option if the option was held on July 18, 1963. Section 2(c)(6) provides as follows:

"OPTIONS AND FORECLOSURES.—Such amendments shall not apply to an acquisition—

"(A) of stock pursuant to the exercise of an option or similar right (or a right to convert a debt obligation into stock), if such option or right was held on July 18, 1963, by the person making the acquisition or by a decedent from whom such person acquired the right to exercise such option or right by bequest or inheritance or by reason of such decendent's death, or

"(B) of stock or debt obligations as a result of a foreclosure by a creditor pursuant to the terms of an instrument held by such cerditor on July 18, 1963."

July 18, 1963, was the date the bill was proposed by the administration.

3. If exercise of an option is taxable, the measure of the 15 percent tax is on the option price, and not on the actual value of the securities acquired. Section 4913(a)(3)(C) provides as follows:

"CERTAIN EMPLOYEE STOCK OPTIONS.—The tax imposed upon an acquisition of stock of a foreign issuer by a United States person pursuant to the exercise of an option or similar right described in section 4914(a)(7) shall be limited to the amount of tax which would have been imposed under section 4911 if the price paid under such option or right were the actual value of the stock acquired."

The House bill does not cover the exercise of employee stock options granted after July 18, 1963.

This is not a request for a general exemption of all exercises of all employee stock options granted after July 18, 1963, but rather an exemption only for such exercises by a U.S. citizen having established a bona fide foreign residence.

The concept of a U.S. citizen who is a bona fide resident abroad is not a new concept to the revenue laws: it is specifically covered by the Revenue Code of 1954, as amended, and invokes existing decisional law. Probably the most common example is a U.S. citizen employed on an indefinite basis by a foreign company outside the United States.

The reason for the limitation is that bona fide foreign residents are typically paid with foreign funds and deposit their income in foreign banks, and, therefore, their income does not usually enter the mainstream of the American economy, and hence, affect the inflow or outflow of dollars. The source of funds to exercise stock options, whether by borrowing or otherwise, is typically derived from the same foreign banks; hence, there is no large outflow of dollars in the exercise of these employee stock options.

The effect of the interest equalization tax would be to inhibit the exercise of newly granted options or options granted in the future, and probably also to inhibit the granting of new options to U.S. citizens.

It is submitted that the proposed tax is not meant to cover such situations since the transactions would have little or no effect on our balance of payments. Although reasonable arguments can be made for the complete exemption of employee stock options, only a limited exemption is here requested.

As previously stated, this testimony is not a request for a blanket exemption for exercises of all stock options, but rather a qualification of the exemption by the requirement that the holder be a bona fide foreign resident during the entire year in which the exercise is made.

It is submitted that the following points are also relevant.

1. The recent changes in the Internal Revenue Code regarding stock options sufficiently restrict their abuse so that no special restriction is necessary in H.R. 8000.

2. Exercise of the stock options by bona fide foreign residents would tend to insure that earnings of U.S. citizens residing abroad would bring back larger estates upon return to the United States, which larger estates would probably be derived from foreign currencies.

3. The proposed amendments recommended by the Treasury Department do not cover this area.

The change sought would be in the form of an amendment to section 4914(a) by addition of a new subparagraph (8) as follows:

"(8) any exercise of a stock option described in subparagraph (7) by a bona fide foreign resident defined in section 911(a)(1)."

The CHAIRMAN. The Chair desires to announce that the record will be held open until Wednesday, July 8, 1964, for submission of written statements on the bill. The committee will now adjourn.

(By direction of the chairman, the following is made a part of the record:)

STATEMENT SUBMITTED BY W. M. POMERENE

POMERENE, BURNS, MILLIGAN & FRASE,
Coshocton, Ohio, March 9, 1964.

Re proposed new foreign investment excise tax.

Hon. FRANK J. LAUSCHE,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LAUSCHE: According to the House committee report, the bill relating to the foreign investment excise tax cannot at this late date be changed before it is submitted to the House.

I further understand that the purpose of the bill is to prevent the outflow of U.S. funds, with which purpose I fully agree.

However, I have called to the attention of the Ways and Means Committee in the House, through the Honorable Jackson E. Betts, a situation which Mr. Betts advises was, apparently, completely overlooked in the House committee and which he suggested I should call to your attention with the hope that you, in turn, will refer the matter to the Senate committee having charge of the above bill.

While this matter undoubtedly involves many similar cases, the situation came to my attention because one of our clients, in 1954, 9 years before there was ever any thought of a foreign investment excise tax, invested (some of his U.S. funds) in a Canadian company and has kept all income from such Canadian investment invested in Canada. U.S. income taxes have, of course, been fully paid on all income therefrom.

From time to time such Canadian funds have been invested in other Canadian companies and from time to time it is advisable to change from one investment to another, all in Canada, and all involved only Canadian dollars. In no case were any U.S. funds involved in such reinvestment—only Canadian funds resulting from the original investment were so used.

Under the wording of the proposed law, it would seem probable that even though only Canadian funds were used, the proposed tax would attach merely because the buyer was a U.S. citizen.

The result would be most unjust since the investment of Canadian-earned funds in Canada would not in any way involve the outflow of any U.S. dollars, since the only money used could be Canadian dollars from Canadian investments.

In the last analysis, the bill, as now drafted, would tax any purchase by a U.S. citizen of any foreign security with any funds, irrespective of whether the funds came from the United States or not. Certainly such is not the intention of the act which is to diminish the outflow of U.S. funds, not to stop the use by U.S. citizens of funds they might properly have in other countries.

I am sure there are many such cases as I have described and I urge that such type of investments, where there is no outflow of U.S. funds, should be recognized and exempted from the proposed tax.

Your attention would be appreciated.

With kindest personal regards.

Most sincerely,

W. M. POMERENE.

BAKER & DANIELS,
Indianapolis, Ind., March 19, 1964.

Re H.R. 8000.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR BYRD: In connection with the forthcoming hearings by the Senate Finance Committee on H.R. 8000, we would like to call your attention to what we believe is an inconsistency between the wording of the act as passed by the House and the purpose of the act as expressed in the House committee report.

We have a client which is the owner of ordinary shares in an English company (Y company). These shares represent less than 10 percent of the outstanding ordinary shares of Y company. Our client would prefer to withdraw its investment from the English company and replace it with investments in securities of U.S. companies. The ordinary shares of Y company have not been readily marketable. Subsequent to January 1, 1964, our client has received an offer from X company, also an English corporation, to exchange shares of X company and cash for the shares of Y company. This offer is one made generally to the holders of ordinary shares of Y company and the offer is conditioned upon acceptance by the holders of 90 percent of the ordinary shares of Y company. The shares of X company have been or are to be listed for trading. It has been the intention of our client, in the event that it received shares of X company pursuant to the offer, to dispose of such shares promptly and withdraw the cash for reinvestment in securities of U.S. companies.

Under section 4912(b)(4) any acquisition of stock in an exchange to which section 351 applies shall be deemed to be an acquisition from the foreign issuer in exchange for its stock. In turn, under section 4914(a)(4) a distribution by a corporation of its stock with respect to or in exchange for its stock does not constitute an acquisition and, therefore, is not taxable. The transaction which has been offered to our client would qualify as a reorganization under section 368(a)(1)(B) except for the fact that cash will be received in addition to the ordinary shares of X company.

The whole purpose of H.R. 8000, as expressed in the report of the Committee on Ways and Means, is to discourage the return of capital to the United States. Our client desires to do exactly that, and yet it would appear that the transaction contemplated by our client is subject to tax. By contrast, a transaction actually qualifying as a B reorganization would not be taxable even though the holder might retain all of his holdings in foreign securities and withdraw no cash from foreign investment.

It would appear that a solution would be to broaden the definition of reorganization exchange under section 4912(b)(4). We suggest that the parenthetical language in line 3 of section 4912(b)(4) be amended to read as follows: "(or would apply, but for section 367 or but for the receipt of cash or other property in a transaction to which section 368(a)(1)(B) would otherwise apply)."

Very truly yours,

JOHN D. COCHRAN.

CHEMICAL INTERNATIONAL FINANCE, LTD.,
New York, N.Y., April 24, 1964.

Re H.R. 8000.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: We wish to bring to the attention of the members of your committee certain inequities in the proposed H.R. 8000 so far as it refers to Edge Act corporations. We feel it is unfair to certain Edge Act corporations to use a yardstick of "accepting deposits" in determining whether the corporation's loans are subject to the proposed interest equalization tax.

The Chemical Bank New York Trust Co. owns Chemical International Finance, Ltd., and Edge Act corporation incorporated in January, 1959. Since its formation, this company has not followed the policy of accepting deposits, yet it has made many millions of dollars of loans and investments which have furthered the policy of the U.S. Government by stimulating exports, assisting in the development of resources in many countries throughout the world, and provided a means of financing international trade.

We have studied the proposed H.R. 8000 carefully and have discussed it at length with our counsel, Cravath, Swaine & Moore. At our request, the latter has prepared the enclosed memorandum which sets forth our viewpoint in greater detail.

Accordingly, we would suggest that Edge Act subsidiaries, irrespective of whether they are regularly engaged in receiving deposits, be treated as if they were commercial banks for purposes of section 4914(b) of the proposed Interest Equalization Act. Also, it is respectfully submitted that the foreign activities of domestic commercial banks are both in the short and long range interests of the United States, and that such activities by such banks, irrespective of whether

conducted directly or through Edge Act subsidiaries, should be permitted to continue to the same degree as prevail today.

We wish to emphasize strongly the difficulties we will encounter in competing effectively with similar foreign-owned institutions and meet terms customarily granted abroad if we are subject to the equalization tax in the 22 countries designated by the President.

Very truly yours,

HOWARD W. McCALL, Jr., *President.*

MEMORANDUM

APRIL 24, 1964.

H.R. 8000

This memorandum is with respect to the proposed treatment of Edge Act corporations under the proposed Interest Equalization Tax Act of 1963. Specifically, the House report accompanying H.R. 8000 in its discussion of section 4914 thereof states as follows:

"A corporation organized under section 25(a) of the Federal Reserve Act (commonly known as the Edge Act), or a State-chartered corporation operating under an agreement with the Federal Reserve Board under section 25 of the Federal Reserve Act, will be considered a commercial bank for * * * purpose (of paragraph a(A) of section 4914(b)) if it is regularly engaged in accepting deposits from customers."

The purpose of the Edge Act is to permit U.S. banks to engage, through subsidiaries, in competing effectively with similar foreign-owed institutions and in relatively risky foreign financing transactions in furtherance of the Government's policy to stimulate local foreign enterprises and international trade by private loan, while at the same time insuring the financial integrity of domestic banks. Edge Act corporations are subject to comprehensive restrictions and supervision by the Board of Governors of the Federal Reserve System and its staff. This regulation and administrative control imposed by the staff of the Board are designed to insure the financial integrity of the Edge Act corporation, and, more importantly, of the parent bank. Accordingly, Edge Act corporations do not have the freedom of operation of other types of foregin investment companies.

Originally, regulation K, promulgated by the Board of Governors, distinguished between an Edge Act financing subsidiary and an Edge Act banking subsidiary, the latter being empowered to accept deposits. Because of this differentiation, those banks which desired to have both types of Edge Act subsidiaries created a dual corporate structure and operating procedures. Subsequently, effective September 1, 1963, regulation K was revised to remove the distinction theretofore maintained between financing subsidiaries and banking subsidiaries. Accordingly, under regulation K as so revised, it would be permissible for an Edge Act corporation to engage in both financing and banking activities, whereas previously two separate and distinct corporate entities were required. Nevertheless, because many Edge Act subsidiaries were incorporated under the prior provisions of regulation K and have been operating thereunder for many years and have built up a considerable amount of good will and international contacts, many banks have not seen fit to revise the corporate structure to place all of the activtiies thereof in one entity.[1] Accordingly, there would not seem to be any valid reason for requiring banks with Edge Act subsidiairies to revise the corporate structure thereof and to change long standing operating procedures merely to comply with the technical requirement of the proposed Interest Equalization Act that the same corporation that makes the investment also accept deposits.

We assume it is not the intention of Congress to penalize the activities of domestic banks through Edge Act[1] subsidiaries—activities which are regulated

[1] Under regulation K as now in effect, if an Edge Act corporation should elect to accept deposits rather than to confine its activities to financing transactions, the only effect upon its operations is that it is not permitted to engage in the business of underwriting, selling, or distributing securities other than obligations of a national government of a foreign country in which it has a branch or agency and is subject to less liberal restrictions with respect to the total amount which it may lend to any one person. In passing, it should be noted that an Edge Act corporation is not deemed to be engaged in the housing of banking for purposes of regulation K unless its aggregate demand deposits and acceptance liabilities exceed its capital and surplus, whereas the test under the proposed Interest Equalization Tax Act would be whether it is regularly engaged in accepting deposits from customers.

closely when conducted through such subsidiaries by the Board of Governors of the Federal Reserve System and cannot be analogized to the activities of non-regulated enterprises. The active participation of U.S. banks in the financing of new or developing foreign enterprises is surely not a type of activity which it is in the national interest to discourage. Clearly, this has been recognized under the Interest Equalization Act by not subjecting loans made directly by a commercial bank to the special tax. It would be anomalous, therefore, if punitive tax legislation were applied to subsidiaries of those banks which are making more risky loans to foreign enterprises than the banks themselves solely on the basis that that subsidiary does not accept deposits. Indeed, the very fact that the loans are being made to developing foreign enterprises and the attending risks are greater than in a situation where loans are made to established foreign enterprises is a cogent argument for not accepting deposits. That is to say, a depositor might consider his deposit to be in greater jeopardy by reason of the nature of the loans being made, and such might act to curtail the ability of the subsidiary to attract deposits. It would appear to us that, if the commercial bank in question is permitted to make a loan which is not subect to the special tax, it should be permitted, if it so elects, to make that same loan through a regulated Edge Act subsidiary which does not accept deposits, and, as stated, would not necessarily be in a position to attract deposits by reason of the nature of its loan portfolio.

Accordingly, we would suggest that Edge Act subsidiaries, irrespective of whether they are regularly engaged in receiving deposits, be treated as if they were commercial banks for purposes of section 4914(b) of the proposed Interest Equalization Act.

However, merely to treat Edge Act subsidiaries, irrespective of whether they are regularly engaged in receiving deposits, as a commercial bank for purposes of section 4914(b) still might give rise to confusion and uncertainty as to whether the exclusion in said act with respect to acquisitions by such subsidiaries of debt obligation would be "in the ordinary course of their commercial banking business." As previously stated, Edge Act subsidiaries have traditionally made loans of a type where the risk is such that it is deemed desirable by both Federal and State regulatory authorities that such loans not be made by the parent bank. Accordingly, historically, loans by an Edge Act subsidiary might not be considered as part of the commercial banking business of a bank, as such, even though they should appropriately be considered as part of the commercial banking business of a bank which has transacted an international banking business directly and indirectly through its Edge Act subsidiaries. Therefore, we suggest that it be made clear that the exclusion of acquisition of debt securities from the proposed tax also apply to loans by Edge Act corporations of a type and dollar volume commensurate with the past corporate and financial history of an Edge Act corporation similarly situated.

In connection with that suggestion, we should like to point out that Edge Act subsidiaries have traditionally engaged in financing newly organized ventures or in the expansion of existing ventures where the risk is of such nature that it does not warrant the borrower obtaining either direct bank credit or financing from other types of U.S. foreign investment media. It must be remembered that U.S. banks are competing abroad with many foreign banks whose powers are not as limited or circumscribed as those of U.S. banks. It should also be stressed that it is the ability to serve enterprises from their incipiency and through their early period of growth which ultimately leads to established banking relationships. Obviously, a foreign enterprise in all probability will establish a bank affiliation with the bank which assisted it during its formative period, whether it be a U.S. bank or a bank of some other country. Once established, such relationship is likely to continue and to become more important to both parties. Accordingly, if foreign entrepreneurs must look to banks of other countries for assistance, a bank in this country will not have the opportunity of attracting to this country the important business relationship of such entrepreneurs and those affiliated with it or who may be influenced by the assistance of the U.S. bank, including the cumulative deposits which such relationships may entail and which are so essential to commercial banking in the United States.

Therefore, it is respectfully submitted that the foreign activities of domestic commercial banks are both in the short and long range interests of the United States, and that such activities consist of the sum total of all activities by such banks, irrespective of whether conducted directly or through Edge Act subsidiaries, and should be permitted to continue to the same degree as prevail today.

CRAVATH, SWAINE & MOORE.

NATIONAL LIFE INSURANCE CO.,
Montpelier, Vt., June 5, 1964.

Hon. GEORGE D. AIKEN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR: Since our very pleasant visit on the telephone the other day, I have been thinking more about the interest equalization tax.

It now appears that our paths will not cross for at least a week or two, and in the interest of time I am taking the liberty to enclose a memorandum which I have asked to be prepared, outlining for you in skeletal form the proposal of interest equalization tax.

As I told you over the telephone, it is my opinion that enactment of this tax would be very unwise for several reasons.

In the first place, the people of Japan are deeply hurt by this action, and I am sure it is easy to understand that they would find it difficult to comprehend why we should take action of this kind when we are sending millions to other parts of the world in the form of foreign aid.

In the second place, the United States cannot expect to maintain a position as a world financial center if we are going to utilize such devices to discourage borrowing in our markets.

In the third place, to my mind this is not coming to grips with the balance-of-payments problem, which can be resolved by more direct and more effective measures without creating the impression of international injustices.

If I can be of further assistance to you in connection with this matter, I shall be glad to do so.

Again I want to thank you for the helpful and generous cooperation which you gave me on my trip to the Orient and Australia.

With warmest regards, I remain

Cordially yours,

L. DOUGLAS MEREDITH,
Executive Vice President, and Chairman, Committee on Finance.

JUNE 2, 1964.

To: L. Douglas Meredith, Executive Vice President and Chairman Committee on Finance
From: Donald H. Tetzlaff, Director of Securities
Subject: Interest equalization tax, H.R. 8000

The interest equalization tax bill (H.R. 8000) was introduced in the House of Representatives on August 23, 1963, reported favorably out of the Ways and Means Committee of the House on December 16, 1963, and passed by the House on March 3, 1964. A very brief summary of the proposed bill follows:

(1) The bill imposes a tax on acquisitions of certain foreign securities in order to equalize the cost of longer term financing in the United States. Simply stated, foreign borrowers have, for some time, been able to borrow money cheaper in the United States than they can in their own countries.

(2) The tax is designed to aid our balance-of-payments position by restraining the heavy and accelerated demand on our capital market from other industrialized countries.

(3) This interest equalization tax is a temporary excise tax effective for the period July 19, 1963 (August 17 for certain listed securities) through December 31, 1965.

(4) The tax rates are designed to reduce the net rate of return to the U.S. buyer on the foreign securities involved, by about 1 percent per annum. It is expected that this will improve the U.S. balance of payments by from $1¼ billion to $1½ billion a year relative to the rate in the first 6 months of 1963. Revenues of $30 million a year are anticipated.

(5) Exclusions in the bill relate to—

(*a*) Securities acquired from a prior American owner;

(*b*) Securities received in connection with a wide range of export transactions;

(*c*) Debt obligations received by commercial banks in the course of their commercial banking business;

(*d*) Direct investments in 10-percent-owned corporations;

(*e*) Securities of "less developed country corporations" and obligations of less developed countries;

(*f*) New security issues which the President exempts in the interests of international monetary stability, presumably new Canadian securities;

(*g*) Reserves maintained by insurance companies doing business in foreign countries; and

(*h*) Investments of foreign membership dues by labor unions and other exempted organizations.

The bill is controversial and the financial community was well represented at the committee hearings. Although the President's announcement came in July of 1963, no law has been passed. The announcement, in effect, stated that any law passed would cover security transactions on and after July 19, 1963, and August 17 for certain listed securities.

The effect of this Presidential announcement has been to practically eliminate new foreign security offerings in the United States. Both issuers and investors are awaiting congressional action on the equalization tax bill. However, 11 months from the announcement, there is no bill near passage as of this writing.

No tax is imposed where the period to maturity is less than 3 years: the following schedule is taken from the bill.

	The tax, as a percentage of actual value, is—
At least 3 years, but less than 3½ years	2.75
At least 3½ years, but less than 4½ years	3.55
At least 4½ years, but less than 5½ years	4.35
At least 5½ years, but less than 6½ years	5.10
At least 6½ years, but less than 7½ years	5.80
At least 7½ years, but less than 8½ years	6.50
At least 8½ years, but less than 9½ years	7.10
At least 9½ years, but less than 10½ years	7.70
At least 10½ years, but less than 11½ years	8.30
At least 11½ years, but less than 13½ years	9.10
At least 13½ years, but less than 16½ years	10.30
At least 16½ years, but less than 18½ years	11.35
At least 18½ years, but less than 21½ years	12.25
At least 21½ years, but less than 23½ years	13.05
At least 23½ years, but less than 26½ years	13.75
At least 26½ years, but less than 28½ years	14.35
28½ years or more	15.00

Because of civil rights legislation, and other bills of greater importance to the administration, no hearings in the Senate have been scheduled (to our knowledge). It is our understanding that if a bill is not passed before December 31, 1964, then a new bill must be introduced and the retroactive features of the present bill will be eliminated.

NEW YORK, N.Y., *June 23, 1964.*

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In my capacity as a vice president in charge of foreign trading of a New York investment banking firm, I received today a copy of the pamphlet containing the amendments recommended by the Treasury Department to the interest equalization tax.

I consider myself an expert in foreign exchange control regulations and have been recognized as such since many years. The so-called interest equalization tax which is nothing else but the first part of the U.S. exchange control regulations, has been conceived by people who either do not know it's implications or are planning to destroy New York as a center of international finance.

It seem odd that at the same time at which this tax should be imposed, a task force on promoting increased foreign investment comes out with a report urging foreign countries to relax on restrictions which might prevent other nations to invest in American securities. Do we really believe that our recommendations will have any success when we do eactly the opposite ourselves?

One of the amendments recommended by the Treasury covers the possibility for dealers in foreign stocks to buy from foreigners on condition that they resell to other foreigners on the same day. On the other hand you can buy foreign bonds from foreigners and resell them to other foreigners within 90 days. Where is the logic? Does the purchase and sale of securities of any kind affect our

balance of payment if both transactions are done with a foreign counterparty? If an American holder of foreign securities wants to sell those he can never rebuy them unless he pays the tax. For all practical purposes this amounts to a forced liquidation of valuable assets by our investing community.

The mere proposal of this law has initially caused massive withdrawal of European dollar balances and has seriously undermined the confidence of foreign financial authorities in this country. Once one starts restricting capital movements the inevitable end is more and more controls and restrictions and our European friends are well aware of this fact.

Up to the moment that I saw the proposed amendments I was hoping that somehow the impact of the law would be softened and legitimate needs of the American investor would be considered. The way it looks now is that only the various regulations have been presented in a more confusing form. I could go on and on explaining why I believe that it will be impossible to police this law and that it will do more harm than good.

I urge you to do whatever possible to prevent this act to become law.

Respectfully yours,

WALTER V. STEINER.

THE AMOS TUCK SCHOOL OF BUSINESS ADMINISTRATION,
DARTMOUTH COLLEGE,
Hanover, N.H., June 24, 1964.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: As your committee considers the interest equalization tax as passed by the House, I hope this letter may be of some help in pointing out features of the legislation that urgently require alteration. I believe the tax as a whole is bad, but I shall confine myself here to some specific defects I see in it.

Switching of foreign investments by U.S. persons

The purchase of foreign securities by one U.S. person from another is exempt from the tax as proposed. This is entirely logical, since the transaction does not involve any outflow of funds from the United States. However, when a U.S. person sells foreign securities to a foreigner and reinvests the proceeds in other foreign securities by purchase from a foreigner, the purchase is subject to tax. Again, there has been no net outflow of funds from the United States and there is no need to penalize the switching of foreign investments; the purchase should be exempt from the tax. To tax the transfer, as the proposed bill would, is not simply to discourage the outflow of funds, but to force U.S. persons to repatriate foreign investments.

Application of the tax to U.S. citizens resident in foreign countries

The tax applies to purchases by U.S. "persons," a term that includes U.S. citizens no mater where they reside. The effect of the tax on U.S. citizens who live and work in foreign countries is quite unreasonable. Consider, for example, a U.S. citizen employed by a Canadian corporation and a bona fide resident of Canda. If he purchases stock in the corporation he works for he will be subject to a 15-percent tax under the proposed terms of the tax. In all probability he will pay for the stock with salary received from his Canadian employer and kept in a Canadian bank account, so that no funds will have left the United States.

The U.S. citizen resident abroad is likely to be more familiar with foreign securities than with U.S. securities, probably derives most of his income from foreign sources and keeps his savings in foreign depositaries. There is little justification for penalizing his normal investment practices and forcing him to send investable funds to the United States.

It is true that the U.S. income tax applies to U.S. citizens regardless of residence. But the interest equalization tax is not an income tax and there is no necessary inconsistency in making it inapplicable to bona fide residents of foreign countries. Even the income tax is subject to exemptions for some foreign income of citizens resident abroad.

The new issue exemption

New issues are the real source of serious outflows of funds from the United States into foreign investments. The proposed legislation permits the President to exempt acquisitions of new securities in order to preserve international monetary stability. It is expected that the President will use his authority to exempt new issues originating in Canada. It would be much more in the interest of the individual U.S. taxpayer to exempt acquisitions of outstanding securities and to tax the acquisition of new issues. So far as possible, the individual U.S. investor should be free to purchase wthout tax penalty any foreign securities which are outstanding and available to him. If the equalization tax is to be applied at all, it should be applied only against new issues.

It should be a good deal easier to enforce a tax on purchases of new issues than to enforce one on purchases of outstanding issues. It is relatively easy to keep track of new issues coming on the market, but difficult to enforce a tax on all purchases by all U.S. persons of outstanding foreign securities unless all transactions in foreign exchange are to be registered.

In conclusion, I hope the commiteee will not be persuaded by the urgency of the gold outflow problem to impose unnecessary hardship on legitimate and profitable foreign investment by individual U.S. citizens.

Yours very truly,

J. PETER WILLIAMSON.

JOINT COMMITTEE ON JAPAN-UNITED STATES TRADE,
Marunouchi, Tokyo, June 19, 1964.

Hon. HARRY FLOOD BYRD,
Finance Committee,
U.S. Senate, Washington, D.C.

SIR: On behalf of the Japanese Joint Committee on Japan-United States Trade, we take great pleasure in sending to you herewith a copy of the joint statement issued at the end of the third Japan-United States Businessmen's Conference held during the week of May 18 here in Tokyo, where the representatives of the Chamber of Commerce of the United States of America and of the Japanese Joint Committee on Japan-United State Trade, made up of the three organizations which we represent, made a frank exchange of views on matters of mutual interest.

As you will note in the joint statement, the representatives of both sides mutually confirmed their stand which is against the enactment of the proposed interest equalization tax bill now pending before your committee. It is the sincere hope of the representatives of the Chamber of Commerce of the United States of America and of the Japanese Joint Committee on Japan-United States Trade that you will kindly give due consideration to our statement.

Yours faithfully,

TAIZO ISHIZAKA,
President, Federation of Economic Organizations.
TADASHI ADACHI,
President, Japan Chamber of Commerce and Industry.
HEITARO INAGAKI,
President, Japan Foreign Trade Council, Inc.

JOINT STATEMENT, MAY 23, 1964

The Third Japan-United States Businessmen's Conference was held in Tokyo on May 19, 20, and 23, 1964, where the representatives of both the Japanese Joint Committee on Japan-United States Trade and of the Chamber of Commerce of the United States of America agreed to issue the following statement.

1. The representatives of the Japanese and American delegations expressed opposition to restrictions to the free flow of capital between the two countries. Specific opposition was expressed to the so-called interest equalization tax bill now pending before the U.S. Senate. Similarly it was recognized that the Japanese Government administration of its laws governing foreign investment effectively hinders desirable capital movement.

2. The Japanese representatives expressed their willingness to cooperate with the United States for the successful conclusion of Kennedy round tariff cutting negotiations in order to lower the barriers of world trade. In this connection, the Japanese representatives expressed their opinion to the effect

that nontariff barriers including discriminatory restrictions imposed by foreign countries upon Japanese products should be removed. The U.S. delegates expressed their understanding of the Japanese position.

3. In view of the desirability of the economic development of the countries of southeast Asia, it was agreed that the representatives of the two countries should explore methods by which private enterprises of Japan and the United States could cooperate in that development and exchange information with each other.

4. The Japanese representatives made a request that the U.S. policies, such as "Buy American" and "Ship American," which restrict the free flow of trade, should be gradually relaxed as the balance of international payments position of the United States improves. As a matter of principle, it was considered undesirable for any country to adopt such policies.

5. As to trade with Communist bloc countries, mutual understanding was deepened as the representatives of both sides presented their views on the matter and explained the present situation in their respective countries.

6. Both delegations held that reciprocity should be the key to closer economic cooperation between the United States and Japan as among all the free world nations.

7. The exchange of frank views on matters of mutual interest at the conference was highly instrumental in promoting mutual understanding and good will between the business circles of the two countries.

Consideration will be given to holding a fourth conference at some mutually convenient date in the United States.

WESTINGHOUSE ELECTRIC CORP.,
Washington, D.C., June 30, 1964.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: Our review of H.R. 8000 has revealed an instance in which the application of the tax proposed by the bill would penalize an American corporation which holds small interests in foreign corporations and which wishes to maintain its proportionate equity when additional stock is offered for subscription. We have prepared an amendment to section 4914(a) of H.R. 8000, as explained and set forth in the attached memorandum, which will correct this inequity without detrimental effect upon the balance of payments.

We respectfully request that the committee review this matter and recommend the adoption of such an amendment.

Sincerely yours,

CLAUDE E. HOBBS, *Counsel.*

SUGGESTED AMENDMENT TO H.R. 8000, THE INTEREST EQUALIZATION TAX BILL

Review of H.R. 8000 has revealed an instance in which the application of the tax proposed by the bill would penalize an American corporation which holds small interests in foreign corporations and which wishes to maintain its proportionate equity when additional stock is offered for subscription.

Westinghouse Electric Corp. maintains investments in foreign companies which often are its licensees or customers for products manufactured by Westinghouse, or both. These investments are in most cases less than 10 percent of the equity. It is often commercially necessary, and when it is not necessary, it is at least desirable, for Westinghouse to subscribe for new stock when it is offered by the foreign company. Where Westinghouse owns, or through the subscription becomes the owner of, 10 percent of the voting power, the tax will not apply. Where ownership is less than 10 percent of the voting power, however, Westinghouse will be forced to pay tax merely to continue its proportionate interest as a stockholder.

It is suggested that the transactions described should be made exempt from the tax. In exempting acquisitions of stock to maintain an existing equity position from application of the tax, the balance of payments can be fully protected by limiting the amount of investment made exempt to an amount equal to the total receipts from the foreign company during the preceding 12 months in the form of dividends, interest, rents, royalties, and sales income. In this

fashion the commercial necessities will be accommodated while the balance of payments is not adversely affected.

A suggested addition to section 4914(a) to effectuate this proposal follows:

"(8) Any acquisition of stock of a foreign issuer to the extent that——

"(A) the proportionate stock interest of such shareholder in the foreign issuer does not exceed that shareholder's proportionate stock interest immediately before such acquisition, and

"(B) the cost of acquiring such stock, plus the cost of acquiring other stock in the same issuer acquired during the preceding 12 months does not exceed the total amount paid by such issuer to the shareholder during the preceding 12 months as dividends, interest, rents, and royalties, and in exchange for export property (as defined in sec. 971(c))."

STATEMENT OF JOHN C. VAN ECK, JR., PRESIDENT OF INTERNATIONAL INVESTORS, INC., AN OPEN-END INVESTMENT COMPANY INVESTING IN FOREIGN SECURITIES

Mr. Chairman and honorable members of the committee, my testimony before the House Ways and Means Committee last August suggested several amendments to H.R. 8000. My concern with the proposed bill was the application of the so-called interest equalization tax to the acquisition of outstanding foreign stocks from foreigners (even if such acquisition were to be paid with foreign currency received from the proceeds of sales of securities to foreigners). Other qualified witnesses pointed out that the proposed bill would be ineffective, unjustified, discriminatory, dangerous and have the effect of depriving Americans of a basic freedom. I wish to submit three additional reasons, which I have not seen mentioned, why I now believe the proposed bill is not in the national interest and should not be adopted.

First, the proposed bill does not correct the basic causes of the differences in interest rates between the United States and Europe and Japan. It will, in my opinion, tend to delay and thereby make more difficult the inevitable adjustment in these rates. The Bank of International Settlements' 34th annual report states that, "The interest equalization tax must be seen as an expedient to cover an underlying disequilibrium between the United States and the outside world." It suggests that the U.S. monetary authorities take the proper action to correct this disequilibrium. If the Federal Reserve System is responsible for the interest rate disparities, it should take the necessary steps to equalize the interest rates, not the U.S. Congress through inadequate stopgap discriminatory legislation.

Second, the proposed bill is inconsistent with the U.S. policy to promote a stronger and more prosperous free world by more efficient allocation of resources and freer exchanges of products and services. The proposed interest equalization tax will place a barrier to international portfolio investment and thus establish a new policy of nationalism and isolationism, a major reversal of the current policy of cooperation with allied countries. Such unilateral action does not build international goodwill in a world where barriers are being reduced and eliminated. The Senate Foreign Affairs Committee should examine this aspect of the proposed bill.

Third, the proposed bill is inconsistent with the U.S. policy to promote increased foreign investment in the securities of U.S. private companies. Does the Senate Finance Committee wish to approve legislation which violates the Golden Rule?

STATEMENT OF U.S. SAVINGS & LOAN LEAGUE, WASHINGTON, D.C., SUBMITTED BY GLEN TROUP, STAFF VICE PRESIDENT, JULY 1, 1964

The U.S. Savings & Loan League, representing over 5,000 member savings and loan associations in every State of the Nation, respectfully requests that the Senate Finance Committee amend H.R. 8000 to give all savings and loan associations the same privileges regarding nonresident alien deposits that banks and most stock savings and loan associations have under existing law and regulations.

Under the present law and regulations by the Treasury Department and the Internal Revenue Service, interest paid by banks on the deposits of nonresident aliens (not conducting a business in the United States) is exempted from Federal income taxes. Internal Revenue and Treasury have ruled that banks and stock associations that pay interest on deposits come within the definition

of "doing a banking business." On the other hand, this same ruling excludes mutual savings and loan dividends from this definition. Yet at the same time, the Treasury Department treats savings and loan dividends as interest in virtually every other area. For example, when it comes to the dividend exclusion or credit in the tax law, dividends by savings and loans are treated not as dividends but as interest. Similarly, under the withholding and reporting laws, dividends paid by savings and loans are treated as interest.

The situation today is neither logical or equitable. In effect, the income from foreign investments in commercial banks and in most stock savings and loan associations paid from the earnings of those institutions are not subject to an income tax. However, if the money is placed in a mutual savings and loan association, it is taxed. This distinction also is true in the case of estate taxes. Thus a nonresident alien's deposit in a commercial bank or stock savings and loan association is not subject to a Federal estate tax (just as the income thereon is not subject to a Federal income tax), yet if the deposit is with a mutual savings and loan association, it is subject to such an estate tax.

The U.S. Savings & Loan League and many other savings and loan representatives have been discussing this matter with the Treasury and Internal Revenue Service for several years. Last year we were informed that the President's Task Force on Foreign Investments would consider our request; however, when the report was issued there was no mention of this problem of nonresident alien income taxes and the different treatment between banks and savings and loans. Repeatedly, requests to alter the interpretations or rulings by the Treasury and Internal Revenue have been denied. The only way that this matter can be treated equitably is through legislation. There is attached language to permit identical tax treatment of nonresident alien funds placed in commercial banks, savings banks, stock savings and loan associations and mutual savings and loan associations. (It treats also the funds of controlled foreign corporations.)

This amendment will help in the balance-of-payments problem. Admittedly, it will not be a tremendous amount involved but the U.S. Savings & Loan League is confident that amending the law as requested will result in millions of additional foreign dollars being invested in our Nation's savings and loan associations. This money, of course, will in turn be invested in home financing. A foreign investor simply cannot understand why if he puts $10,000 in a commercial bank or a stock savings and loan association there is no tax on the earnings and no withholding. Yet if he places $10,000 in a mutual savings and loan association, the dividends paid thereon are subject to a withholding of up to 30 percent. Also of course, if the foreign investor died, estate taxes would be levied against sums in the savings and loan associations but not on sums in a commercial bank, as has been explained above.

The suggested amendment will not only remove an inequity between competing institutions, but will aid our Nation in helping to resolve the balance-of-payments problem.

We sincerely and respectfully request that H.R. 8000 be amended per the attached amendment.

AMENDMENT OF H.R. 8000—COMMITTEE PRINT, DECEMBER 6, 1963

Add at the end of the committee print of the bill (beginning at the bottom of p. 71) the following further amendments:

"Sec. 6. Bank deposits of nonresident aliens and controlled foreign corporations

"(a) INTEREST AS GROSS INCOME FROM SOURCES WITHIN UNITED STATES.—Subparagraph (A) of paragraph (1), subsection (a), section 861, subchapter N, chapter 1 is amended to read as follows:

"'(A) interest or other earnings on deposits or savings accounts with banks (as defined in section 581) paid to persons not engaged in business within the United States,'

"(b) TAX ON NONRESIDENT ALIEN INDIVIDUALS.—Paragraph (1) of subsection (a), section 871, subchapter N, chapter 1 is amended to read as follows:

"'(1) IMPOSITION OF TAX.—Except as otherwise provided in subsection (b) there is hereby imposed for each taxable year, in lieu of the tax imposed by section 1, on the amount received, by every nonresident alien individual not engaged in trade or business within the United States, from sources within the United States, as interest (except interest or other earnings on deposits or saving accounts with banks as defined in section 581), dividends, rents, salaries, wages,

premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including amounts described in section 402(a)(2), section 403(a)(2), section 631(b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets), a tax of 30 percent of such amount.

"(c) EXCEPTIONS FROM DEFINITION OF TERM 'UNITED STATES PROPERTY'.—Subparagraph (A) of paragraph (2), subsection (b), section 956, subchapter N, chapter 1 is amended to read as follows:

"'(A) Obligations of the United States, money, or deposits with persons carrying on the business of banks, as defined in section 581;'

"(d) WITHHOLDING OF TAX ON NONRESIDENT ALIENS.—The first sentence of subsection (b) of section 1441, subchapter A, chapter 3, is amended to read as follows:

"'(b) INCOME ITEMS.—The items of income referred to in subsection (a) are interest (except interest or other earnings on deposits or savings accounts with banks as defined in section 581 paid to persons not engaged in business in the United States), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, and amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets.'

"(e) TAX ON ESTATE OF A NONRESIDENT NOT A CITIZEN OF THE UNITED STATES.—Subsection (b), section 2105, subchapter B, chapter 11, is amended to read as follows:

"'(b) BANK DEPOSITS.—For the purposes of this subchapter, any moneys held by banks (as defined in section 581) the interest or other earnings from which is excluded from gross income from sources within the United States for the purposes of chapter 1, subtitle A, for a nonresident not a citizen of the United States who was not engaged in business in the United States at the time of his death shall not be deemed property within the United States.'"

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC., SUBMITTED BY JOSEPH H. BRADY, VICE PRESIDENT, NEW YORK, N.Y., JULY 1, 1964

The National Foreign Trade Council, which was organized in 1914, is comprised of U.S. companies which either directly or through their domestic and foreign affiliates are engaged in all aspects of foreign trade and business. Generally, the activities include production in the United States for export, production abroad, distribution to and in foreign countries of tangible and intangible goods of both United States and foreign origin, and furnishing services both to and in foreign countries. Among the specific activities are: manufacturing, merchandising, extracting, exporting and importing, conduct of transportation and communication businesses, banking and insurance. Frequently a single company will be engaged in several or all types of activities—e.g., it will export goods and services from the United States and produce and sell goods abroad.

The basic purpose of the National Foreign Trade Council is to promote and protect American foreign trade and business. NFTC has urged continuously that American foreign trade and business which constitutes an extremely important integral segment of our total economy be fostered, recognizing that there is an interrelated need for strengthening U.S. foreign trade and business, U.S. business generally, and the U.S. economy as a whole.

The balance-of-payments problem has been one to which the National Foreign Trade Council has given continuing attention. We have commented on a number of occasions concerning the unfortunate impact on the international position of the dollar and on our gold reserves of a protracted overall deficit in the balance of payments. In this connection, attention has been invited to the positive contributions of private foreign trade and business to the balance of payments, both from a short-term and a long-term point of view. Receipts from American exports and direct investments abroad, and American foreign trade and business generally, constitute major factors in the positive side of U.S. balance of payments. (See NFTC's testimony before the Committee on Ways and Means, June 5, 1961, "The President's 1961 Tax Recommendations," hearings, vol. 4, p. 2628 et seq.)

According to the Treasury, the "Interest Equalization Tax Act of 1963 (H.R. 8000, 88th Cong.) occupies a central position in our total effort to achieve prompt and lasting improvement in our balance of payments by reducing the flow of long-term portfolio capital from this country. The purposes of the bill are achieved through the imposition of a temporary excise tax on the acquisition from foreigners of foreign stocks or debt obligations with maturities of 3 years or more."

As indicated above, the National Foreign Trade Council's members are engaged in activities involving production abroad, distribution of tangible and intangible goods, both in foreign countries and to persons located in foreign countries, and similarly furnishing of services of both United States and foreign origin to and in foreign countries. In general, they are engaged in activities which come within the meaning of the concept "active conduct of a trade or business." Within this framework our comments are addressed to the aspects of the bill which affect those activities; our statement should not be taken as being for or against the basic concept embodied in H.R. 8000—namely, the imposition of an excise tax on foreign portfolio investments.

As introduced, many long-term financial transactions of both a contractual and equity type entered into during the active conduct of such foreign trade or business would have been subject to the new tax if H.R. 8000 as introduced had been enacted into law.

Specific exemptions from the tax on long-term financial transactions of U.S. companies engaged in the active conduct of a trade or business were included in the bill as introduced. Further, these were broadened to some extent in the bill as passed by the House. Finally, a number of the amendments recommended by the Treasury Department and which were transmitted to the chairman of the Committee on Finance, June 12, and subsequently published by the committee, appear to alleviate the impact of the bill on companies engaged in the active conduct of a trade or business.

However, it is noted that the amendments recommended by the Treasury have been available only for a short time (as a practical matter, approximately a week) and have not been thoroughly studied by all concerned. While the Treasury has generally seemed to be sympathetic to the suggestions of U.S. companies engaged in the active conduct of foreign trade and business, the time available to study the proposed amendments has made it difficult to be certain that all appropriate cases are adequately covered.

In testimony before the Committee on Ways and Means[1] the basic suggestion of the National Foreign Trade Council was that if H.R. 8000 or a similar bill is enacted into law it should contain provisions exempting from the imposition of the tax all transactions which are related to the active conduct by a U.S. company of any type of foreign trade or business. This is the basic recommendation of the National Foreign Trade Council at the present time.

If H.R. 8000 or a similar bill is enacted into law, NFTC supports in principle those provisions in the bill which in whole or in part mitigate the application of the proposed tax, insofar as it would adversely affect financial transactions of U.S. companies engaged in the active conduct of a trade or business.

U.S. Senate Committee on Finance—H.R. 8000, Interest Equalization Tax Act

Statement of Henry Scharf, Weston, Conn.

Introduction

The within statement is in opposition to H.R. 8000, the proposed Interest Equalization Tax Act.

I would like to state at the outset that the concept of H.R. 8000 appears to be needed legislation to curb the outflow of U.S. dollars and to reduce the balance-of-payments deficit as reported by the Treasury Department and the President in his message to Congress of July 18, 1963. In the quest for relief many statements have been made by the Treasury Department which have no real basis in fact, and other aspects of the proposed legislation have been completely ignored. It is therefore imperative that an accurate analysis be made as to the sources contributing to the balance-of-payments deficit.

[1] Hearings before the Committee on Ways and Means, House of Representatives, 88th Cong., 1st sesss., on H.R. 8000, p. 307 et seq.

During the year 1962 and the first half of 1963 many hundreds of millions of dollars worth of new issues were placed on the U.S. securities market. These new equity and debt issues accounted for the bulk of U.S. dollars leaving this country without any direct return to the United States. Most of these issues were underwritten on behalf of Japanese, West German, and Canadian companies. There is no question but that new financing should be curtailed, as is envisioned in H.R. 8000. Since the proposal of this tax most of the financing has taken place outside of the United States. Some of this financing has been placed abroad by American underwriters. Whether or not Americans participated through oversea holdings in this new financing is not known. What is known, however, is that the purchase and sale of existing equity and debt issues has not only not contributed to the balance-of-payments deficit but, on the contrary, has brought substantial new dollars into this country. It is this phrase of H.R. 8000 that we object to and it is this phase of H.R. 8000 which has not received the proper consideration, nor have figures been made available by the Treasury Department.

It is our contention that the Interest Equalization Tax Act if enacted into law specifically excludes the purchase of existing foreign securities and particularly differentiates as to existing foreign securities presently trading on any of the recognized U.S. securities exchanges.

Comments regarding the trading in outstanding Canadian and United States securities between Canadian citizens and United States citizens

In the 28-month period from January 1, 1962, to April 30, 1964, U.S. citizens purchased $870.3 million of outstanding Canadian securities. During the same period U.S. citizens sold back to Canadian citizens $1,036.5 million of outstanding Canadian equities, making a net balance rehabilitated to Canada of $166.2 million. This means that not only did U.S. citizens, in their dealings with existing Canadian securities, not contribute to the balance-of-payments deficit but contributed an additional $166.2 million into U.S. income from foreign countries.

In the 4-month period from January 1, 1964, to April 30, 1964, U.S. citizens sold back to Canadians $145.9 million of outstanding Canadian securities while only purchasing $89.6 million. Thus in the most recent 4-month period $56.3 million was received by U.S. citizens in excess over their purchases. Here again the balance-of-payments deficit was thus reduced rather than aggravated. By the same token, in the 4-month period of January 1, 1964, to April 30, 1964, Canadian citizens purchased $142.6 million worth of U.S. securities from U.S. citizens and sold $134.2 million of U.S. securities back to U.S. citizens making a net purchase of $23 million. In the 4-month period ended April 30, 1964, Canada contributed $79.3 million to the United States as its net balance between purchases and sales of United States and Canadian securities.

To summarize: Canadians are purchasing more U.S. equities than they are selling while, at the same time, repatriating more Canadian equities from the United States than they are selling to the United States.

A table of the purchases and sales of Canadian securities, as well as the purchases and sales of U.S. citizens follows:

Trading in outstanding U.S. preferred and common stocks (between Canada and United States)

[In millions]

	Sales to U.S. purchasers	Purchased from U.S. sellers	Net sales (+) or purchases (−)
April 1964	$40.0	$47.2	−$7.2
Jan. 1 to Apr. 30, 1964	134.2	142.6	−8.4

Trading in outstanding Canadian common and preferred stocks (between Canada and United States)

[In millions]

Year and month	Sales of common and preferred Canadian stocks to United States residents	Purchases of common and preferred Canadian stocks from United States residents	Net sales (+) or purchase (−)
1962 (year)	$543.1	$554.7	−$11.6
1963 (year)	237.6	335.9	−98.2
1964 (4 months)	89.6	145.9	−56.3
1963:			
January	28.4	42.6	−14.2
February	25.5	29.5	−4.0
March	28.8	40.7	−11.9
April	26.8	39.8	−12.9
May	26.5	38.9	−12.4
June	22.4	26.4	−4.0
July	17.9	18.0	−.1
August	9.3	16.0	−6.7
September	9.8	17.1	−7.3
October	11.8	23.3	−11.5
November	16.1	23.7	−7.6
December	13.9	19.5	−5.6
Month not identified	.4	.4	
1964:			
January	21.2	41.6	−20.5
February	17.8	23.9	−6.0
March	18.9	36.8	−18.0
April	31.7	43.6	−11.8

Comments regarding trading in outstanding foreign securities and U.S. securities between all foreign citizens and U.S. citizens

During the calendar year 1962 all foreign citizens combined purchased $2.232 billion of U.S. securities and sold back to U.S. citizens $2.150 billion, thus trading by foreigners in existing U.S. securities contributed over $82 million to the U.S. balance of payments.

In 1963 foreign citizens as a total purchased $4.850 billion worth of existing U.S. securities and sold back to U.S. citizens $3.97 billion, thus contributing for the calendar year 1963 over $880 million to our balance of payments.

In his message to Congress of July 18, 1963, the President stated that American purchases of foreign securities totaled $1.2 billion and that the estimated 1963 purchases would total $1.5 billion. No figures have been cited as to the dollar amount repatriated to foreign countries by U.S. citizens during the same period of time. While exact figures are not available to us, on a worldwide market-by-market basis a spot check of the London market indicates a reduction in the foreign exchange reserve by U.S. citizens rather than an increase. This reduction is estimated at approximately 20 percent. If this were to be translated into total securities purchased by Americans from foreign citizens it would indicate that these transactions have reduced our annual balance-of-payment deficit by at least another $300 million, thus for the year 1963 the purchases by foreign citizens of U.S. securities and the net equity returned to U.S. citizens would be in excess of $1.180 billion.

We find no indication that trading in existing foreign securities by American citizens contributes in any way to the deficit in U.S. gold reserves. It would appear from the above figures that such trading produces net income to the United States from foreigners and if anything tends to help the balance of payments rather than contribute to its deficit.

Comments regarding tourism by U.S. citizens and foreign citizens as compared with securities trading

During the calendar year 1963 Americans in their travels abroad will have spent $3.19 billion, while foreign citizens coming to the United States will have spent approximately $1.5 billion. American tourism abroad without question accounts for $1.75 billion in the annual balance-of-payments deficit. Nowhere within H.R. 8000 do we find a tax imposed upon American citizens traveling abroad. Nowhere in H.R. 8000 do we find the imposition of a tax by American citizens purchasing steamship or plane tickets for travel abroad. This we

believe would be a similar parallel as to imposition of a tax on a purchase of existing foreign securities by American citizens. The billions of dollars spent each year by American citizens traveling abroad leave nothing except fond memories of a vacation or business travel. Foreign securities purchased by American citizens leave an equivalent equity with these citizens which at some time or another are repatriated to the foreign country in return for a profit or another equity for the U.S. citizen. To tax the purchase of foreign securities would indeed be shortsighted. Investments are usually made for a profit motive. If this is true, at some time in the future, more money will come into the United States as a result of these purchases by U.S. citizens than will be taken from our dollar reserve. The present figures all indicate that this is so.

Comments regarding borrowings by foreign citizens from U.S. sources as differentiated from the purchase and sale of existing foreign issues by U.S. citizens

In a description of the proposed interest equalization tax as submitted to the Committee on Ways and Means of the House of Representatives by the Treasury Department, it is stated as follows: "The administration for some time has pointed out that a portion of these foreign needs for capital now met from U.S. sources might more appropriately be satisfied in the borrower's own market or in those of countries with balance-of-payments surpluses. The imposition of the proposed tax will encourage this process by tending to equalize costs of longer term financing in the United States and in markets abroad, reducing the incentive to raise capital in the United States simply to take advantage of a possible interest cost saving."

It is an elementary fact that a company having issued its securities does not receive the proceeds of the purchaser's sale of these securities while trading in an open and free market. Only if the company issues new securities does it receive the proceeds from such sale. The trading in existing foreign securities by U.S. citizens does not produce financing for the companies whose securities are thus traded. A large Canadian steel producer whose securities are traded on an American stock exchange does not receive the proceeds from each days trading. A Dutch electronics company trading on the New York Stock Exchange does not receive the proceeds of each day's trading in its securities. It is therefore imperative that the proposed legislation accomplishes what it sets out to do. If it is the intent of the legislation to reduce the outflow of dollars for new equities or debt financing by foreign corporation then the bill will have accomplished its purpose. Taxing new purchases of equities or debt securities by U.S. citizens of foreign corporations is an effective means of accomplishing the Treasury's aims. We fail to see, however, where taxing the purchase of existing and freely trading securities anything would be gained in the outflow of dollars other than to stop the trading of already existing foreign securities. Even more important, might not such a tax on existing issues also bring a retaliatory tax on the purchase of American securities by nationals of another country? The risk of such a retaliation would have deprived the United States of over $880 million in the calendar year 1963 and would probably deprive the United States of more than a billion dollars for the calendar year 1964.

Comments regarding the administrative problems encountered in H.R. 8000

The bill as passed by the House of Representatives provides a tax on all securities purchased by American citizens from foreign citizens and in addition to a number of exemptions, also includes an exemption from the tax on those purchases of a foreign security of which the issuer is more than 50 percent owned by U.S. citizens. This by itself would create an insurmountable administrative burden. A foreign corporation may well be 51 percent owned by Americans on one day and not the next. In order for an American citizen to purchase the securities of a foreign issuer he would first have to contact the secretary of the corporation involved or the treasurer of the government involved to ascertain whether at the time of his purchase the list of stockholders indicated 51 percent ownership by American citizens. While it is true that an American purchaser could rely on the affidavit furnished by his broker in the event the security is purchased on a recognized American exchange, the purchaser however would be deprived of his right to purchase the security in another market. A typical example would be the case of the Canadian Pacific Railroad. This corporation being domiciled in Canada must be deemed a foreign issue. Its shares are traded on all Canadian exchanges, on the New York Stock Exchange and the Pacific

Coast Exchange in the United States. They are also traded on the Paris Bourse. At one time this year this corporation was 51 percent American owned. It may not qualify under this exemption today. Its shares are usually purchased most economically on the Paris Bourse. They can also be purchased from any recognized Canadian exchange for approximately 3 percent less than on the New York Stock Exchange. Like shopping for the most advantageous price in goods or services, an American citizen should not be deprived of his right to shop for the best possible price for the securities he may wish to own.

During the latter part of 1963 the U.S. Treasury exempted the shares of International Nickel, another Canadian corporation, from the tax pursuant to the exemption provided for in the bill of corporations owned in a majority by U.S. citizens. The status of International Nickel ownership by American citizens could rapidly change if large holdings by funds or other trusts were to be liquidated to non-U.S. citizens. If this were to occur, a U.S. citizen owning these shares might well find a substantially weakened market for his securities if trading practices would discount the potential tax from the price of the security. It must be recognized that the primary market would usually be within the country of origin of the security and that the U.S. securities markets in most cases follow the price fluctuations of the primary market of the issuer of the security.

The Treasury Department, in its most recent amendments, recommended to the committee proposals to exempt certain types of arbitrage operations by "dealers." Nowhere within the bill is the word "dealer" defined and if it is the intention of the Treasury to limit arbitrage operations only to brokers and dealers who are members of a registered U.S. exchange, then this provision would be discriminatory as to arbitrage operations conducted by individuals or corporations who are not broker-dealers within the definition of the Securities and Exchange Commission but who are dealers for their own account and their own risk. It is our belief that section 4919 should be clarified to allow for arbitrage operations by any firm or individual without regard as to his classification or business.

It should also be pointed out that it is the feeling of eminent constitutional attorneys that the retroactive provision of the bill to August of 1963 would legally not be valid and that in view of the changes which are proposed and which will be made in the bill as to the original version passed by the House of Representatives, the retroactive provision would place in jeopardy those persons or firms who purchased or sold securities applicable to the tax during the past year. It is certainly no more than fair that if H.R. 8000 is enacted in its final form that due notice be given of the final version of the bill with an effective date reasonably enough in the future so as to provide a guide for the future conduct of firms or corporations or securities dealers.

Conclusion

It is self-evident from the figures submitted that an interest equalization tax would only be of help to the U.S. balance of payments if it confined itself to the issuance of new equity or debt securities by foreign corporations. The tax should not be imposed upon previously issued and freely trading securities. The enactment of such a tax could have an adverse effect upon the balance of payments and could conceivably produce some form of retaliatory measures by other governments against the purchase by their nationals of U.S. securities. The effect of the tax would be harmful upon the securities markets in the United States and deprive American citizens of their free choice of purchase and investment. There could also be more far-reaching repercussions. It could depress the securities markets of Canada and some of the major markets of Europe and impair our foreign relations with these countries. It could create more anti-American feeling and bring about a planned program of retaliation by foreign governments against U.S. securities markets.

The bill presently recognizes, in the case of debt obligations by foreign corporations, that no tax shall be applicable for maturities under 3 years. An analysis of holdings of equity securities will indicate that they are rarely held for even a period up to 3 years.

The bill could encourage the issuance of short-term debt obligations with a conversion factor, thus defeating the intent of the bill and causing a much larger outflow of U.S. dollars. Any temporary tax imposed upon new issues should be imposed with due notice and not made retroactive.

Statistical sources:

Canadian securities trading data, Toronto Stock Exchange.
U.S.-foreign securities trading data, New York Stock Exchange.
Travel expenditures, U.S. Department of Commerce.
British securities trading data, the London Stock Exchange.

JOINT STATEMENT SUBMITTED FOR AMERICAN LIFE CONVENTION BY GLENDON E. JOHNSON, GENERAL COUNSEL FOR LIFE INSURANCE ASSOCIATION OF AMERICA, AND BY EUGENE M. THORE, VICE PRESIDENT AND GENERAL COUNSEL

The American Life Convention and the Life Insurance Association of America are two associations with a joint membership of 323 life insurance companies which have approximately 95 percent of the total assets of all U.S. legal reserve life insurance companies. The purpose of this statement is to present the views of these associations with regard to some of the general economic questions raised by H. R. 8000.

The life insurance business appreciates the vital importance of determined Government measures to reduce and ultimately eliminate the deficit in the U.S. international balance of payments. Since 1958 this country has piled up an aggregate payments deficit of $18.4 billion. This year, however, there appears to have been a substantial improvement in this position. This is due at least in part to the inflation which has been occurring in Europe, coupled with our own general price stability, and thus the enhanced competitive position of our goods and services in foreign markets.

We, of course, favor sound action to correct the deficit in our balance of payments. The only question is what are the best steps. We have serious reservations about the soundness of the interest equalization tax as a measure to restrict portfolio investments abroad.

1. Despite claims to the contrary, this proposal moves toward direct control over capital outflows. In other contexts the administration has rejected such control as "contrary to our basic precept of free markets." It is not consistent with our traditional policy of encouraging freer international trade and full convertibility of currencies.

2. Since it approaches direct control, and departs from the free market pricing mechanism, the legislation must contain a number of exemptions. This brings about difficult legislative decisions as to types of loans that should be exempt, and can result in discrimination and unfairness as between different participants in the capital market. It also presents extremely complicated administrative problems—for example, the policing of commercial bank loans to insure that they are not used as a substitute for long-term securities issues. In this connection, it is significant that commercial bank lending abroad, both short and medium term, increased markedly in 1963, particularly after the interest equalization tax proposal was introduced. The total rose from less than $400 million in 1962 to $500 million in the first half of 1963 and to $780 million in the second half (seasonally adjusted). Medium-term loans were $120 million out of the 1962 total and $580 million out of the 1963 total.

3. Other countries faced with payments deficits occasioned by capital outflows—for example, Canada and Great Britain—have traditionally employed monetary policy and interest rate changes to cope with the problem. The wisdom of a tax approach will be questioned by foreigners. Thus the tax may provoke retaliation by other countries, not only in the capital funds area but also in possible restrictions against our exports. It may worsen the climate for broadening world trade under the Trade Expansion Act.

4. The proposal is advanced as a means of reducing long-term capital outflows without departing from a policy of maintaining very easy long-term credit and low long-term interest rates at home. This fails to recognize that under present conditions less easy long-term credit in this country and moderately higher long-term interest rates would be desirable. After 4 years of easy credit availability largely as the result of Federal Reserve policy, the availability of financing has reached the point of excessive ease in certain areas of the long-term credit market. This is especially true in the mortgage market. This is not good for the health of our economy.

5. There is real question about the effectiveness of the interest equalization tax. Many authorities are convinced that a renewed outflow of long-term capital will occur once the tax has been enacted. Thus, there is a definite

possibility that the administration will shortly be forced, in any event, to employ the monetary tool and higher long-term interest rates to deal with the problem.

There are a number of reasons, we think, why the better approach would be for the monetary authorities to encourage and permit a moderate rise in domestic long-term interest rates. This approach would avoid the difficulties outlined earlier which are inherent in the interest equalization tax and would at the same time be effective in meeting the problem. Investing institutions in this country have a natural preference for placing their funds domestically. The decline in long-term interest rates (one-half to three-quarters of 1 percent since 1959) is largely responsibile for the increased interest of U.S. investors in higher yielding foreign securities. A moderate rise in long-term domestic interest rates would go far toward reversing this trend.

In our judgment, the moderate increase in interest rates needed to check the flow of capital abroad would not impede our domestic economic expansion. It has been our experience that business concerns are not appreciably deterred by rising borrowing costs so long as profit expectations on new investment expenditures are promising, as we expect them to be in the foreseeable future. It has also been our experience that a moderate rise in the interest rate on home mortgages, accompanied by sounder credit arrangements, has little effect on the rate of residential construction. Accordingly, the concern that a rise in long-term rates would reverse the general business expansion seems to us to be unjustifiable. This is particularly true under today's circumstances in which financial institutions already have huge backlogs of forward commitments to buy securities and to make mortgage loans at interest rates prevailing in the past year.

There is a danger that the combined stimulus of the Federal tax cut and easy credit will push the national economy in the months ahead into an unsustainable rate of expansion with the possibility of a serious setback after business has moved to peak levels. In recognition of this danger, it would be desirable for the monetary authorities to move toward a somewhat lessened availability of credit. The moderately higher long-term interest rates which would result would largely remove the need for the interest equalization tax.

The life insurance business strongly supports Government policy directed toward reducing unemployment and encouraging expansion of our economy. We want an improved rate of economic growth on a sustainable basis, consonant with stability of the general price level. An increase at this time in long-term interest rates, which would aid to reduce the balance-of-payments deficit and also help to maintain general price stability, would make an important contribution to sustainable long-term growth of our economy.

In summary, the life insurance business strongly supports action to correct the deficit in the U.S. international balance of payments. We have, however, serious reservations about the soundness and effectiveness of the proposed interest equalization tax as a measure to correct the rise of portfolio investments abroad. We believe that the best way to check the outflow of long-term capital would be to permit and encourage a moderate rise in domestic long-term interest rates. Finally, we are convinced that a moderate rise in long-term interest rates would aid rather than retard sustainable economic expansion in this conutry and would be to the advantaoge of the American economy in the long run.

GROLIER, INC.,
New York, N.Y., July 1, 1964.

Re proposed H.R. 8000, Interest Equalization Tax Act.

COMMITTEE ON FINANCE,
U.S. Senate, Washington, D.C.

GENTLEMEN: Grolier, Inc., is a publisher of encyclopedias, reference books, and educational materials. The $115 million of annual sales volume is principally made direct to the customer on the installment plan with repayment terms ranging up to 36 months at present. An increasing proportion of its sales is made directly to individual residents of foreign countries. With an investment of $32 million in plates and inventory, the parent company currently publishes many of the books sold abroad through branches of domestic and foreign sales subsidiaries. Depending on market conditions the foreign sales may involve adaptation of domestic publications, editions published outside the United States, or foreign publications purchased from outside sources to supplement the company's publications.

Financing is necessary to enable the company to advance the cost of printing, pay sales commissions and cover the cost of carrying and collecting the installment accounts. It is difficult to sell such retail installment receivables except at an excessive discount since there is no tangible security for payment. A large financial base is required to obtain a loan with such receivables as collateral. The cost of manufacturing is a small part of the face value of the installment receivables.

The company's publications contribute to the rising standard of education and literacy abroad which in turn contributes to the spread of democratic institutions and viewpoints. The ever-increasing thirst for knowledge of all countries and peoples has created a substantial foreign market for the company's publications. The company must act swiftly or it might lose these markets to foreign competitors.

The company is fearful that the interest equalization tax bill as it was passed by the House of Representatives will hinder its ability to compete effectively with foreign competition by subjecting its operation to the tax in two ways.

First.—The bill as it now stands would subject any sales on terms of 36 months or more to a tax unless the export credit exemption is available. This requires a large percentage of the merchandise to be manufactured or produced in the United States. According to a statement in the House committee report technical explanations of the bill regarding section 4920(a)(7)(A), "each installment of a debt obligation payable in installments is deemed to have a separate period remaining to maturity." In such case the tax would be limited to the portion of payments due after 35 months unless the export credit exemption applied.

Any tax would be payable immediately and would add to the financial burden of the company since the money would not be recoverable from the customer for 36 or more months. Further, the company experiences substantial returns and bad debts. These transactions would apparently be taxable in full even though no money was ever collected. Since the proposed tax would operate like a sales tax, relief provisions common to sales taxes excluding uncollected sales should be added to erase hardships if it is to apply to installment sales of merchandise. The income tax law avoids this by permitting the company to pay its taxes as the accounts are collected under the installment sales method.

The recordkeeping and reports required to analyze each sale to each individual to determine the tax status of the sale would be very considerable. New reporting procedures would be necessary at considerable expense since records do not show at present the origin or combination of publications included in each sale. It would be impractical to install such procedures if the amount of tax was small.

Other difficulties involve the apportionment of the sales price of a combination offer in determining what percentage was produced in the United States for purposes of eligibility for the export credit exclusion contained in section 4914(c). This arises because of the following attributes of the company's business. Sales made to each customer consist of a package of publications chosen by the customer from alternative selections and extras and the mixture of publications in the package is determined by customer preference. The company conducts an "information service" in which it agrees to answer questions submitted by subscribers to its publications. There is no independent price for the various items in the sales package.

With regard to export credit exclusion itself, the company feels that it is not broad enough since it limits relief to the sale of property a percentage of which is "manufactured" or "produced" in the United States. The terms "manufactured" and "produced" are not defined in the bill so as to make clear their interpretation when applied to the publishing industry. Since the company subcontracts the printing and binding of its products, it may be held not to be the "manufacturer" or the "producer" of its publications and, therefore, might not qualify for the alternative export credit exemption for producing exporters depending upon the interpretation of the words "manufacture" and "produce" when outside processing operations are involved.

In the report of the Committee on Ways and Means dated December 16, 1963, on the proposed bill at "III. General Explanation, b. Exemptions from the tax, 6. Other Exemptions Provided," it is stated: "In general, these exemptions have one factor in common, however: the acquisition of the foreign securities is due to factors other than the interest rate differential between American and foreign security markets."

We believe that an exemption in our case would meet this criteria since the installment sale to foreign individuals on terms of 36 months or over would be dictated by competitive conditions not relative interest rates. Since the proposed bill if read in conjunction with the House committee report as pointed out above already exempts thirty-five thirty-sixths of a particular sale, it would be desirable to exempt all installment sales to permit leeway for future business conditions dictating longer terms. An installment sale should be exempt on the same terms as a cash sale where the differential in interest rates is not a factor in the terms of the sale.

Grolier is attempting to expand its foreign business and operations. In the long run the installment receivables acquired either directly or through foreign subsidiaries will contribute to a favorable balance of payments. The proposed bill unless further amended will inhibit the acquisition of such foreign income-producing assets and defeat its purpose. Without amendment the proposed bill would add to the growing number of business decisions being influenced by tax rather than economic conditions. Therefore, a blanket exclusion would help this taxpayer without detracting from the purposes of the proposed bill.

Second.—The acquisition of stock or debt obligations of, or from, the company's foreign subsidiaries might be subjected to tax immediately or retroactively if these subsidiaries sold on terms of 36 months or more. This would hinder the entry of the company into new foreign markets and might also prevent desirable corporate operational realinements.

The following sections might affect the company:

1. Section 4912(b)(2) taxes a transfer of money or property to a foreign corporation in the nature of a contribution to capital. It also taxes acquisition of debt if the obligor foreign corporation itself acquires foreign stock or debt.
2. Section 4912(b)(3) treats the acquisition of stock or debt of a domestic corporation as taxable if its purpose is to raise funds for a foreign obligor or issuer.
3. Section 4912(b)(4) treats certain reorganization as acquisitions which may be taxable.
4. Section 4914(g) provides retroactive taxability of transactions exempted as export credit transactions if the obligations are transferred to another U.S. person while the tax is in effect. This would preclude transfers of obligations between affiliates or to outsiders other than banks. This could hinder necessary corporate financing needs.
5. Section 4915 excludes direct investment of stock or debt if a 10-percent voting interest is held. However, the exclusion is voided if the foreign corporations are formed or availed of to acquire foreign stock or debt. Since the company's subsidiaries acquire installment obligations these exemptions could be lost for reasons unrelated to interest rate differentials.

The proposed bill exempts export credit transactions and direct investments in foreign subsidiaries. For the reasons explained above these exemptions may be ineffectual in the company's case. If the company sold its products for cash it would be exempt from this tax (1) on transfers of money or propert to its subsidiaries, (2) on acquisition of their stock or debt, and (3) on foreign sales of the foreign branches of its domestic subsidiaries. It would be exempt on its sales regardless of the origin of its publications and the language of the export credit exemptions, since terms would be less than 36 months. On transactions with its subsidiaries the direct investment exemptions would be available. What the company wishes to bring to the attention of the committee is that these exclusions and exemptions should not be unavailable or retroactively lost to the company possibly many years later, merely because the nature of its product requires sales to be made on the installment basis. In addition the company becomes involved in the intricacies of the Export credit exemption solely due to its installment basis and not because it lends money to its customers or to others.

The company believes that its operations will contribute substantially to a favorable U.S. balance of payments in future years and any measure which would hinder the growth of its foreign markets or impair its ability to compete with foreign firms would be damaging to the balance of payments in the long run.

Therefore, the company would like to respectfully submit proposed amendments to the bill.

PROPOSED AMENDMENTS

Section 4914. Exclusion for certain acquisitions

(b) *Excluded acquisitions.*—The tax imposed by section 4911 shall not apply to the acquistion—

This amends section 4914(b) to add a new paragraph (8) after paragraph (7) as follows:

"(8) *Installment sales at retail.*—Of stock or debt obligation arising from installment sales at retail of tangible personal property to a nonresident alien individual."

As an alternative, one of the following might be submitted:

1. "(8) *Retail sale of books.*—Of stock or debt obligation arising from the sale at retail of books, printed matter or educational devices."
2. "(8) *Retail sales under $1,000.*—Of stock or debt obligations arising from sales at retail of property where the invoice price does not exceed $1,000 to any one customer in any calendar year."
3. "(8) *Balance of payments.*—Of stock or debt obligations in transactions, the effect of which is, not adverse to the balance of payments."

In conjunction with this a paragraph (8) should be added to the definition at section 4920(a) as follows:

"(8) *Manufactured or produced.*—A person shall be considered to have 'manufactured' or 'produced' items in the case of a publication, if he is the person having the right (by ownership or lease) to publish the items so manufactured or produced and controls the production and sale of the items produced therefrom."

It also should be made clear, as pointed out previously, that "each installment of an obligation payable in installments is deemed to have a separate period remaining to maturity," by adding words to this effect to the definitions in section 4920(a) as a new paragraph (9). This would be preferable to being forced to rely on the statement to this effect in the House committee report.

Finally, transfers or reorganizations between or among a parent company and its 50 percent or more owned subsidiaries should be exempted from the tax, or from loss of otherwise available exclusions, so that business efficiency will not be impeded in the future by the inability to realine corporate operations.

The amendments recommended by the Treasury Department to your committee as follows are endorsed by the company.

Revised subparagraph—	which appears in the printed proposed amendments at page—
4913(c)	8.
4914(g)	19 and 20.
4914(i)	21 and 22.
4915(a)(1)	22 and 23.

However, it would be desirable if the relief in the proposed Treasury amendments to section 4915(a)(1) was expanded to cover the company's situation where the products may be manufactured or assembled by a domestic or foreign affiliate rather than by the transferor subsidiary.

Thank you for this opportunity to bring these matters to your attention.

Very truly yours,

JOHN E. GOYDAN,
Controller, Taxes.

STATEMENT OF NEW YORK CHAMBER OF COMMERCE, SUBMITTED BY MARK E. RICHARDSON, EXECUTIVE VICE PRESIDENT, NEW YORK, N.Y.

The New York Chamber of Commerce, the oldest business organization in the United States, is located in the heart of the Nation's financial center, and it includes in its membership representatives of most of the leading financial institutions in the city of New York. For nearly two centuries the chamber has maintained a close and continuing interest in matters of public policy affecting finance and trade, domestic and international.

The chamber is opposed to the enactment of H.R. 8000—the so-called interest equalization tax proposal—and it expressed this opposition (in August 1963) at the hearings held on the measure by the Committee on Ways and Means of the House of Representatives. It is the considered and unanimous opinion of the committees of the chamber which have evaluated the proposal, that it would be a serious error for the United States to impose, further, the restrictions on

the free flow of investment funds that are contemplated by H.R. 8000. The chamber recommends that the Senate Finance Committee reject the bill.

In the judgment of the New York Chamber of Commerce, imposition by the United States of the interest equalization tax would do, and possibly has already done, serious damage to the effective functioning of the free world capital markets and the international monetary system of which the dollar is the bulwark. It is a matter of considerable concern to us that the bill, although not yet law, has already had a disruptive effect. Because of its retroactive effective date of July 19, 1963, trading in certain types of foreign securities has virtually come to a halt in the New York market. This has led to a diversion of business to other capital markets to the disadvantage of New York and of the United States.

The interest equalization tax has been advanced as a temporary means of meeting the balance-of-payments difficulties with which our Nation has been confronted in recent years. It is designed to curb the outflow of American investment funds, through the imposition of an import levy on foreign stocks and bonds. It is, in fact, a form of exchange control. It is not a tax for revenue, but a tax to control and restrict. It is discriminatory, in that it delegates to the President and to the Internal Revenue Service discretionary powers of application and exemption.

Perhaps the most serious aspect of the interest equalization tax proposal is that it is a case of nationalistic protection which could reverse the trend toward liberalization of international economic relationships that we have tried so hard, and spent so much money to establish. Inevitably, adoption of the proposal by the United States would invite retaliation from abroad; and, in fact, this may already have occurred. One unfortunate result could be a worsening of the free world's financial structure.

It is highly doubtful that the interest equalization tax would have any appreciable beneficial effect in easing the balance-of-payments problem; and in its long-range consequences it is clear that it would work to the detriment of our balance of payments, inasmuch as the United States would suffer a reduction in earnings from investments abroad—earnings which in the past have consistently exceeded the so-called capital outflow.

With respect to the balance-of-payments problems itself: Significantly, the record of the past 9 months shows that the balance-of-payments deficit has been markedly eased. The improvement in our position has been due to two factors: a substantial increase in our own exports vis-a-vis imports; and a relative decrease in our Government's expenditures abroad. According to available data, the interest equalization tax—which has been operative in fact, if not in law, because of its retroactive features—has had only a minor effect on our payments position.[1] The evidence seems clear that the proposed tax could have only a minimal influence at best on the balance of payments; and the chamber holds that the unfavorable consequences that would result from the imposition of the tax would far outweigh the minor and temporary benefits, if any, that might be achieved.

As had been indicated in several recent reports by the New York Chamber of Commerce, there is no easy, magic solution of our balance-of-payments difficulties, and we delude ourselves if we postpone coming to grips with the basic fundamentals of our payments problem by resort to questionable and temporary expedients such as the interest equalization tax.

Our basic strategy, in meeting our payments problem, should be to make investment here relatively more attractive. We, in the chamber, have placed major emphasis on the achiemement of those policies which would promote confidence in the U.S. economy, both here and abroad. We supported a reduction in income tax rates, both individual and corporate, in order to spur investment in new and improved plant and equipment. We have recommended rigorous control of Government expenditures, domestic and foreign, in order to achieve a balanced budget and insure the stability of the dollar. We have urged our Government to press our free world allies to encourage them to bear a larger share of the costs of mutual defense and the free world obligations to the developing areas. We have encouraged and supported public and private efforts substantially to increase the sale of American goods and services abroad, and thus to increase our already preponderately favorable trade balance in goods and services.

---

[1] See "The Balance of Payments During the First Quarter of 1964." Survey of Current Business (U.S. Department of Commerce, June 1964).

This is the positive and liberal approach to the solution of the balance-of-paymnts problem, and it is a matter of considerable gratification to us that application by our Government of several of these policies in recent months has already led to an easing of the payments deficit. We urge that the Government intensify its efforts to meet the payments problem through further implementation of these fundamental policies. If such policies are pursued diligently and consistently, the payments deficit will soon disappear.

We will only be harming ourselves if we are diverted by devices such as that set out in H.R. 8000, which can offer no fundamental solution to the underlying problems, and which conflict with all of our hopes and aspirations for an efficiently functioning free world society.

NEW YORK, N.Y., *June 30, 1964.*

STATEMENT OF J. R. TIMMINS & CO., NEW YORK, N.Y.

J. R. Timmins & Co., 37 Wall Street, New York, N.Y., is a member firm of the New York, American (associate), Toronto, Montreal, and Canadian Stock Exchanges. In addition to New York City, it maintains branch offices in Montreal and Toronto, from which it engages in Canadian international arbitrage.

The capital interest of J.R. Timmins & Co. is owned by a Canadian citizen and resident, but in order to be eligible for membership on the New York Stock Exchange, the firm became a New York State partnership nearly 35 years ago. Thus, for purposes of H.R. 8000, the firm is a U.S. person, subject to the proposed 15-percent interest equalization tax on the fair market value of all securities it purchases on the foreign market of the New York Stock Exchange or on the Canadian exchanges for resale in such foreign markets to non-U.S. citizens. As stated by Secretary Dillon earlier in these hearings in a reference to arbitrage, these transactions are beyond the stated purpose and intended scope of H.R. 8000 and cannot affect the balance-of-payments problem.

The Treasury Department, accordingly, has recognized that J. R. Timmins & Co., and all others similarly situated, should have relief from the exceptional hardship which H.R. 8000 otherwise would impose on it, and some measure of relief has been recommended to this committee by the Treasury. This proposal by the Treasury, however, is inadequate to provide the relief which is essential to enable Timmins to continue its business of Canadian international arbitrage for the following reasons:

1. The firm cannot comply with the reporting requirements to establish the identity of a buyer in the foreign market for the reason that Timmins has no knowledge of the identity or nationality of such buyer.
2. The same-day rule which requires the sale of foreign stock to a foreigner on the date of acquisition is too restrictive to permit the normal operation of arbitrage and, hence, to permit Timmins to remain in business.
3. The retroactive effective date of the bill imposes a severe potential tax liability.

The Treasury proposal would grant a credit against the tax imposed by the bill "if a dealer acquires foreign stock in the ordinary course of his business and sells the stock on the same business day to a foreigner." Thus, the proposal establishes the so-called same-day rule on resale and requires proof that such resale is to a foreigner.

In its arbitrage transactions, Timmins receives no information regarding the identity or nationality of the buyer in the foreign market in which it sells foreign securities, is not entitled to this informaion, and is unable to obtain such information. Sales in the foreign market normally are to brokers who, because of business reasons and custom, do not identify the purchaser by name or nationality and may not be required to do so by any seller. It is possible that the New York Stock Exchange could adopt rules to require a broker entering the foreign market to state whether the buyer is a foreigner, but such a requirement does not now exist and there is no assurance that it would be adopted by the exchange. Accordingly, in the absence of such an exchange requirement, Timmins could not comply with the reporting features of the bill. However, if this requirement were modified to provide that sales of foreign securities in the foreign market raise the presumption that such sales are to foreigners, so long as the arbitrageur has no information to the contrary, Timmins could comply.

The proposed same-day rule is far too restrictive to permit the normal operation of arbitrage for the following reasons:

1. Frequently, buy orders placed by Timmins early in the day are not reported executed until after the close of the market on that day, and in a few instances Timmins is not notified that a purchase has been consummated until the following day.

2. The proposed 1-day rule imposes an unreasonable and unnecessary limitation upon the free exercise of market judgment. Generally, arbitrage is credited with tending to stabilize disorderly markets, but forced sales on a falling market to comply with a 1- or 2-day rule would aggravate the disorderliness of the market instead of tending to stabilize the market.

3. Timmins buys and sells many securities in its arbitrage transactions during the normal course of its business day. Consequently, as of the close of a business day, it is not certain whether Timmins is long or short with respect to a particular security or securities. Usually, the earliest such a determination is made is the next day.

The same-day rule is too restrictive to permit J. R. Timmins & Co. to remain in business.

Conceptually, arbitrage is the purchase of a security in one market accompanied by a simultaneous sale of the same security in another market. In practice, however, such transactions seldom are, in fact, simultaneous and frequently require several days to complete. While 95 percent of the arbitrage transactions entered into by Timmins are completed within 1 business day, the remaining 5 percent poses the problem. On its face, 5 percent is a small percentage. Nevertheless, according to Timmins' records, the potential tax liability with respect to this 5 percent would exceed the profit made from all transactions. Consequently, Timmins must have relief as to these past transactions, which are not within the stated purpose of the legislation and which caused no gold outflow, in order to be able to continue in business.

It is for this reason and principle that Timmins earnestly requests this committee to extend the so-called same-day rule to 5 days. Such an extension would harm no one and would simply provide equitable justice for Timmins. Timmins did not believe that it could be affected by the legislation for arbitrage in the foreign, United States, and Canadian markets, none of which transactions in any way contributed to the balance-of-payments problem. When it was advised by counsel that these arbitrage transactions were within the purview of the bill as written because Timmins was a U.S. person, it ceased arbitrage until it had conferred with the Treasury and determined that relief would be forthcoming.

If the retroactive effective date is advanced to the date of enactment and at least a 3-day rule is provided for future transactions, Timmins will be able to continue in business. But, unless the retroactive effective date is advanced to the date of enactment or a 5-day rule is adopted, Timmins' operations will be severely crippled because of the potential tax liability with respect to 5 percent of its past transactions. And, unless a 3-day rule is adopted for future transactions, Timmins, will be unable to continue in business and compete with its principal competitors who for the most part are not confronted with any time limitation for completing their arbitrage transactions.

There are two methods basically for conducting arbitrage transactions: (1) by the arbitrageur buying and selling for his own account, as a principal; and (2) by the arbitrageur acting as a broker or agent.

Insofar as Timmins has been able to determine, there are only two arbitrageurs who operate as principals and, therefore, would be affected by this bill. These two, of which Timmins is one, because of their extensive investments in memberships on the New York Stock Exchange and on two or more Canadian exchanges, are permitted by the rules of the exchanges to engage in arbitrage transactions as principals, buying and selling for their own accounts. It is only in this frame of reference and in the broadest sense of the term that these two arbitrageurs could be classed as dealers. In fact, even such a general characterization is a misnomer and completely misleading.

A dealer is one who intentionally takes a position for purposes of speculation or investment and maintains an inventory of securities for purposes of the market as either an exchange function or for his own customers. Timmins, as an arbitrageur, never intentionally retains securities in inventory for any purpose. When Timmins acquires stock, the acquisition is solely for purposes of immediate resale to capitalize on the spread in markets. Its desire is to unfreeze its capital, and to repeat the process at the earliest possible time. Only when the arbitrageur who buys and sells for his own account is faced with a loss prior

to the completion of his transaction, does he hesitate to sell. This is readily understandable because the profit in arbitrage transactions is very small, while the potential loss from such a transaction, handled as a principal, can be substantial.

At the end of any given business day, Timmins may be left with an unintentional and unwanted inventory for the following reasons: (1) it was not notified until after the close of the market of a purchase; (2) it was unable to determine as of the close whether it was long or short with respect to a given issue; or (3) it did not have sufficient time before the close of the market to sell out the number of shares it had purchased either because it was unable to locate a buyer or because competitors had satisfied the demand.

The U.S. arbitrageur who elects to operate as a broker or agent by way of contrast (1) is required to be a member of but one exchange; (2) derives his profits from commissions; and (3) may not be subject to any time limitation, because he buys and sells as agent for a foreign dealer.

Consequently, for the above reasons, a 5-day limitation, restricted to those engaged in arbitrage as principals is required and should be approved by this committee.

SUMMARY

J. R. Timmins & Co. respectfully and earnestly urges that:

1. The proposed "same-day rule" be extended to 5 days if the effective date is not moved forward to the date of enactment, and that if the date of enactment becomes the effective date, such limitation be extended to a least 3 days.

2. The provisions of the amendment be limited to firms engaged in arbitrage as principals.

3. The reporting requirement be modified to provide that sales of foreign securities in the foreign market raise the presumption that such sales were to foreigners, so long as an arbitrageur has no information to the contrary.

INTERNATIONAL MINERALS & CHEMICALS CORP.,
Skokie, Ill., July 1, 1694.

Re H.R. 8000, Interest Equalization Tax Act.

Hon. HARRY F. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The purpose of this letter is, first, to request that the bill labeled H.R. 8000 not be reported out of your committee for action by the Senate; that it be turned down as a measure not needed for the purpose intended; that in lieu thereof other ways and means best known to your good office be used to accomplish the balance of payments.

If it is in your considered opinion that H.R. 8000 is "must" legislation, I respectfully request that the following amendment be made to section 4917:

"If the President of the United States shall at any time determine (a) that the application of the tax imposed by section 4911 will have such consequences for a foreign country as to imperil or threaten to imperil the stability of the international monetary system, and (b) that such foreign country does not discriminate through the exercise of its taxing power or otherwise against investments made by citizens of the United States in such foreign country at the time of such determination, he may by Executive order specify that such tax shall not apply to the obligation of such foreign country, * * *."

Further, I note that it is the opinion of Treasury that this tax is to be a temporary tax. I don't think we should be misled by Mr. Dillon's statements, for the reason that history will show that once a tax is enacted, even though enacted as a temporary or emergency measure, the temporary or emergency nature never ceases to exist. If the bill is to be enacted, it should bear the provision that it is enacted for a specific period only and that it is not extendible.

Your consideration of the above in your present determinations will be greatly appreciated.

Yours very truly,

C. M. EDWARDS.

CENTRAL SOYA,
Fort Wayne, Ind., July 1, 1964.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The purpose of this letter is to express the strong opposition of our company to the Interest Equalizaton Tax Act, which proposes a 15-percent tax on Americans investing abroad through the purchase of foreign securities.

In our opinion, this is a direct penalty on every American business that is investing abroad, as business has been encouraged to do by the Federal Government itself.

It is not only inconsistent but expensive to American taxpayers for the Department of Commerce to encourage American business to be active abroad, while another agency of the Government proposes taxes to discourage such activity.

As businessmen, we know that if we are going to sell abroad we must invest abroad. This is the only sound approach for expanding world markets for the long pull. Although investments in underdeveloped countries are currently excepted from the tax, industry cannot make long-range investment plans in these countries on the assumption that this will continue to be the case since, on 30 days' notice, the exclusion can be terminated by the President.

Finally, if private U.S. investment is curtailed abroad, will this not stimulate increased demands for U.S. Government spending in nations receiving foreign aid, and thus not only defeat the purpose for which the tax is proposed but tend to make foreign aid a never-ending program?

Respectfully,

HAROLD W. MCMILLEN,
Chairman of the Board.

STATEMENT OF G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE, NEW YORK, N.Y.

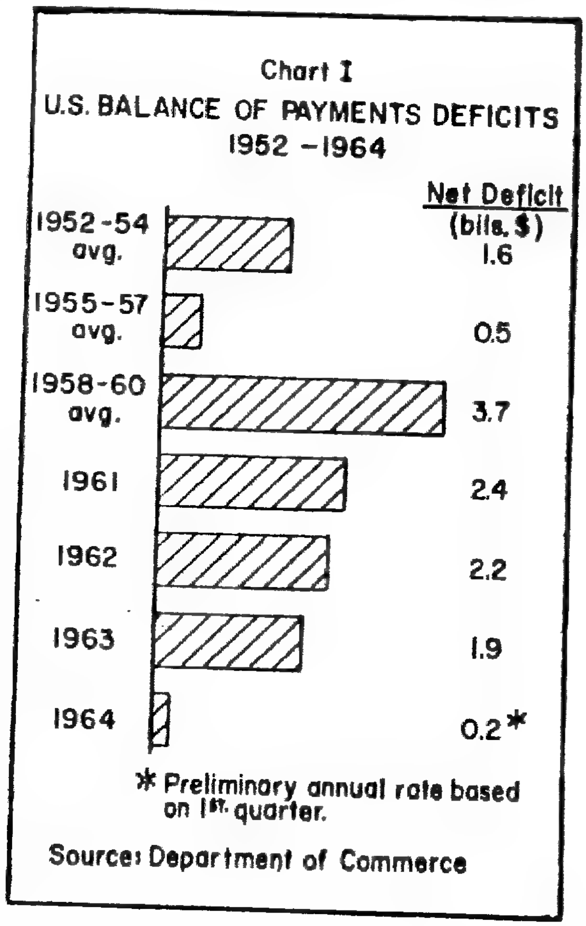
This statement is intended to reflect the views of the exchange community regarding the interest equalization tax. It is therefore limited to those areas in which we may have special competence; i.e., the issuance and trading of securities. In formulating these views, I have been able to draw upon experience gained as a member of the Presidential Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad.

OUTLOOK FOR THE BALANCE OF PAYMENTS

Recently, President Johnson announced that the improvement recorded in our balance of payments during the last half of 1963 had continued through the first quarter of 1964. As chart I shows, the first quarter figure for the payments deficit was at an annual rate of $200 million, compared to the $1.9 billion deficit recorded for the full year of 1963. While improvement of this magnitude in our international accounts is gratifying, it would be premature to assume our payments problems are solved.

Working with the Presidential task force led me to one overriding conclusion: there is no simple solution to our balance-of-payments problems. The international flow of funds area is replete with complex relationships and involved technical considerations. Any country, be it the Netherlands or Nigeria, attempting to master its international payments situation, is faced by difficult questions. These issues, however, are compounded when we come to the United States, for we serve as the world's banker and our dollars represent a great part of other countries' financial reserves. Thus, the United States must constantly keep in mind its special responsibilities when designing corrective actions in the payments area.

The complex nature of these responsibilities is indicated by the fact that even as this committee considers a proposal to reduce the flow of dollars abroad, other experts both within and without Government are contemplating the problems that may develop if and when the United States earns a payments surplus. Thus, for a nation as dominant in world affairs as the United States, a payments surplus will not eliminate payments problems: it will merely change their dimensions and direction. The balance-of-payments dilemma as a fact of inter-



national economic life for years to come, seems destined to be a subject requiring thoughtful and regular attention by Congress and the administration. It is essential, therefore, to seek out solutions to the problem through fundamental and long-range programs.

NEW APPROACHES TO PAYMENTS PROBLEMS

Before World War II, the orthodox or traditional approach had generally been followed in settling payments deficits. First, gold or other monetary reserves were allowed to flow out to satisfy deficits resulting from international transactions. If this failed or was deemed inappropriate, the deficit country might turn to internal adjustments such as changes in monetary and fiscal policy and adjustments of tariffs and quotas. These changes sometimes tended to retard economic development in the deficit country, and often proved politically difficult to make. If the deficit nation was one of the more developed countries, any changes made could also adversely affect the economies of other countries.

Recent approaches have not been revolutionary. They have evolved slowly as monetary authorities worked to meet the ever-changing international payments problems. While these changes are not new to those involved in day-to-day operation of international payments machinery, they may go unnoticed by the vast majority of us as alternatives—even if only partial and temporary—to the earlier approaches to settling international payments problems.

The first change is the growing use of international organizations, such as the International Monetary Fund, in aiding deficit countries to meet temporary situations. Moreover, multilateral agreements, such as the one concluded recently between Italy, the United States, and others to support the lira and provide Italy with credit, are also becoming quite common.

The second is the recognition that a strong, growing domestic economy often helps to eliminate or reduce payments deficits. A strong economy encourages foreign funds to flow in, while discourging the flow of funds abroad. This argument was used by the administration in support of the Revenue Act of 1964, and is especially relevant for the United States, which normally is an exporter of capital.

The third is more use of persuasion. Deficit countries have encouraged surplus countries to remove or reduce tariffs and quotas and to liberalize capital restrictions, and thus reduce the imbalances in reserves among countries. At the same time, deficit countries have also attempted to change the habits and tastes of foreigners, as well as their own citizens, to use more of the deficit countries' goods and services.

The evolutionary developments in meeting temporary fluctuations of a country's payments position are only part of the changing picture of international payments. Various international multilateral and bilateral bodies are giving this problem continuous study. While there is no simple solution, as I pointed out, the outlook is certainly much brighter today than it was as recently as 5 years ago.

Thus, if one were to take the monetary pulse of the world today, the diagnosis would be a growing cooperation and understanding among nations. While the pulse is not yet robust and regular, it is apparent that a healthy economic world requires continued multilateral and bilateral cooperation in the international payments area.

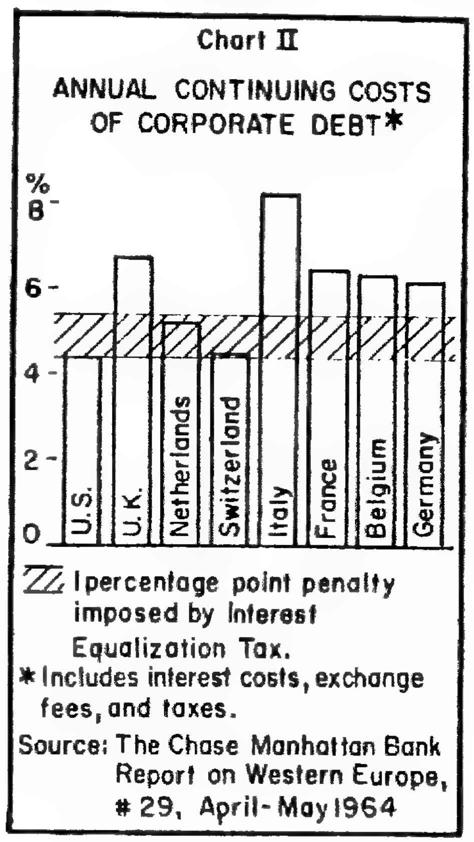
THE INTEREST EQUALIZATION TAX PENALTY

It seems strange, therefore, to find the administration continuing to urge the interest equalization tax which is out of step with the trend toward international cooperation, inconsistent with other U.S. policies in the international field, and alien to our own history of promoting free capital movement. The interest equalization tax would impose a penalty on purchases of foreign securities from foreigners by U.S. persons for the period from July 19, 1963, to December 31, 1965. The tax on debt obligations would vary from 2.75 percent for obligations with a maturity of 3 to 3½ years to 15 percent on obligations with a maturity of 28½ years or more. There would be no tax on debt obligations with a maturity of less than 3 years. The tax on stock would be a flat 15 percent. The objective of the tax is to raise the effective interest rate on foreign debt issues by 1 percentage point and thus, bring U.S. rates in line with those of other capital markets. It is assumed that this increase would reduce foreigners' demand for capital in the U.S. market.

Because of its retroactive features, the tax has already provided most of the temporary relief that it can to our payments position. The severe turnabout in the flotation of new debt issues recorded in the second half of 1963 was influenced strongly by the uncertainties of the final form of legislation and not by the specific features contained in the House-passed version. If the tax is passed, despite the 1-percentage-point interest penalty, foreign corporations and countries would return to the long-term debt market as before, although probably not at the rate of the first half of 1963. Foreign corporations or governments will simply adjust the coupon rate (discount the price) to reflect the interest equalization tax for the U.S. purchaser. It is not unusual to have different bond issues outstanding with different interest rates.

As chart II shows, even with the additional 1 percentage point added to debt interest, only Switzerland and the Netherlands would have average interest charges lower than those available in the United States. And these two countries, besides imposing rather stringent capital controls, have little capital available above their own needs for export. There would, therefore, be no great increase of foreign debt issues in their markets.

Further, as chart III shows, all of the countries on the average have issue costs for debt considerably higher than those for the United States. Thus the tax, while tending toward "equalization" of yields, would not eliminate the advantages of the U.S. capital market and would only slightly deter foreigners from entering the U.S. long-term debt market.



AN "EQUITY DISCRIMINATION" TAX

As for issuance of foreign equities, however, the situation is entirely different. A corporation coming to market with a new equity issue does not have the flexibility discussed above for bonds. The dividend policy is determined by profits and is not a contractual agreement. Moreover, dividends cannot be adjusted for a particular area or country. The price paid for one share of stock is the price of every share and the dividends paid on one share must be paid on all shares. The 15-percent penalty on U.S. purchases of foreign stocks could, therefore, effectively prevent any foreign equities from being sold in the United States. The tax is labeled an interest equalization tax. As far as equities are concerned, it might better be labeled an "equity discrimination" tax.

The purchaser of foreign stocks would be required to pay a minimum premium equal to the premium on debt issues held for 28½ years or more. Should circumstances change prior to that time, the equity holder has paid a greater penalty than that imposed on the holders of debt securities. As table I shows, the discrimination or added premium imposed on $100 of equity as opposed to $100 of debt is substantial. For stocks held 3 years or less the discrimination is $15 for every $100 of foreign stock purchased. Even for stock held as long as 13½ years, the discrimination amounts to $5.90 per $100.

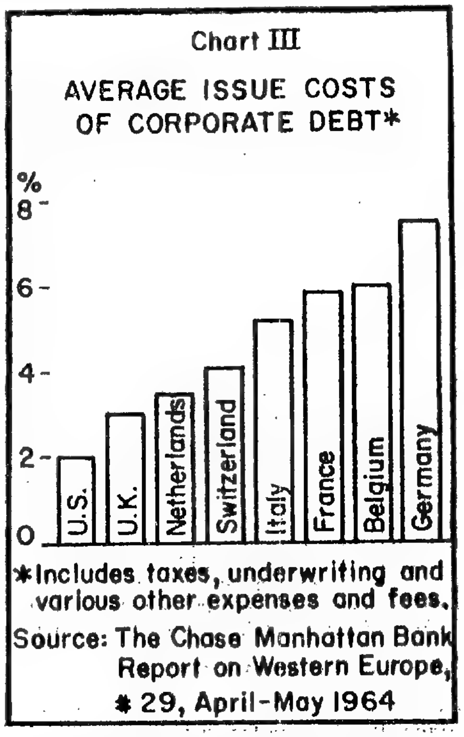


TABLE I.—*Added premium imposed by interest equalization tax per $100*

Maturity/period held	Bonds	Stocks	Added premium on stocks over bonds
Up to 3 years	0	$15	$15.00
3 to 3½ years	$2.75	15	12.25
3½ to 4½ years	3.55	15	11.45
4½ to 5½ years	4.35	15	10.65
5½ to 6½ years	5.10	15	9.90
6½ to 7½ years	5.80	15	9.20
7½ to 8½ years	6.50	15	8.50
8½ to 9½ years	7.10	15	7.90
9½ to 10½ years	7.70	15	7.30
10½ to 11½ years	8.30	15	6.70
11½ to 13½ years	9.10	15	5.90
13½ to 16½ years	10.30	15	4.70
16½ to 18½ years	11.35	15	3.65
18½ to 21½ years	12.25	15	2.75
21½ to 23½ years	13.05	15	1.95
23½ to 26½ years	13.75	15	1.25
26½ to 28½ years	14.35	15	.65
28½ years or more	15.00	15	0

An example of the discrimination discussed above is found in the section of the bill dealing with the tax to be imposed on bonds convertible into stock. If the convertible bond has over 5 years to maturity, it is taxed as a bond—i.e., taxed at a rate sufficient to increase the effective interest rate by 1 percentage point. However, if and when the bond is converted, the owner would be liable for an additional tax penalty to make the total tax paid 15 percent.

If, on the other hand, the convertible bond has 5 years or less to maturity, it is taxed as a stock and subject to the full 15-percent tax penalty immediately. The buyer of this convertible bond is subject to an additional tax penalty whether or not he converts to stock.

Thus, for bonds of roughly the same maturity between 4½ to 5½ years, the tax penalty would vary from $4.35 per $100 for nonconvertible bonds to $15 per $100 for convertible bonds maturing in 5 years or less. Convertible bonds with a maturity of over 5 years would be subject to an immediate tax penalty of $4.35 per $100 and an additional tax of $11.65 ($15 minus $4.35) per $100 only if and when the bond were converted.

EXEMPTIONS FROM THE INTEREST EQUALIZATION TAX

Had the tax been in force in 1963, exemptions for international organizations, less-developed countries, and Canada would have eliminated from coverage about $1.7 of the $2.7 billion raised by foreigners in the United States. The tax would, therefore, have applied to only 37 percent of the total. The justification for exempting these countries and institutions is that their need for funds is urgent and cannot be satisfied fully elsewhere. Moreover, most of these countries presently hold small dollar reserves, and thus pose no direct threat to our gold reserve.

On the other hand, the tax applies to those countries which the administration believes capable of satisfying capital needs internally or in other capital markets. Further, many of these countries now hold large amounts of U.S. dollars, and might demand gold for any additional U.S. dollars they acquire.

While these arguments appear reasonable on the surface, they have serious shortcomings. The exempt countries may well only serve as a conduit for funds raised in the United States. They may use at least part of the funds raised in the United States to buy goods and services from developed countries. Thus, the potential demand for U.S. gold is only somewhat reduced.

IMPACT ON CAPITAL MARKETS

The tax should not be passed, even as a temporary measure. Passage would offer only limited relief to our balance-of-payments position, while imposing restrictions on U.S. capital at a time when we are encouraging others to open their capital markets to foreigners. Enactment of this tax will serve as a precedent for any country to justify imposing or continuing restrictions on capital flows, and raise questions about U.S. intentions in the whole payments area.

Moreover, this tax will retard the growth of the United States as the focal point of the world's capital markets—a growth that until recently was wholeheartedly supported by the U.S. Government. I refer to the development of facilities, technology and trained people to handle world capital needs, not just the United States as a source of funds. The retroactive provisions of the bill passed by the House have already shifted some of these services abroad. While shifting of this kind is helpful in building better capital markets abroad, the real need is not for moving scarce facilities from one market to another but for an increase in total facilities.

Furthermore, foreigners may in the short and medium term liquidate their holdings of U.S. securities, if they feel this tax is only a first step by the United States to restrict the international flow of funds. While this may not now be a serious consideration, an impairment in foreigners' confidence could develop into a major factor almost overnight.

Finally, future flows of dividends and interest to the United States will be reduced as U.S. investors become net sellers of foreign securities. As chart IV shows, income from all private foreign nondirect investment has grown from $260 million in 1955 to over $900 million in 1963. The average annual growth of over $80 million makes this one of the fastest growing sources of funds in U.S. foreign accounts. While these figures include interest paid on short-term loans, most of this income represents dividends and interest on long-term securities.

EXEMPTION FOR NEW AND OUTSTANDING FOREIGN STOCKS

What is particularly disturbing about the tax is the provision taxing stocks at a flat rate of 15 percent. As demonstrated earlier, the continuing lower average annual and issue costs for bonds (including the tax penalty) would have

permitted much of the debt securities issued in 1963 to be economically sold to U.S. citizens. Thus, while some marginal reduction in the amount of gross foreign bond sales would have occurred, there would have still been a considerable market.

This would not be true for foreign stocks purchased by U.S. citizens. The tax penalty is so discriminatory and heavy on all purchases of stock, that very little if any of the foreign stocks would have been sold in the United States. The elimination of a market for foreign stocks is certainly not an objective of the tax proposal.

The theory was that an effective 1 percentage point increase for debt issued in the United States would make foreign markets competitive with the United States. As Secretary of the Treasury Dillon said in his statement before the Ways and Means Committee: "* * * a reasonable prognosis may be a reduction in the outflow of capital from this country into new foreign bond and stock issues back toward the range of $500 to $700 million that prevailed from 1959 to 1961." This could be done in theory by the tax on debt issues but not on stocks. The tax on bonds is progressive and increases with the maturity of the bond. The tax penalty on stocks is a fixed flat 15 percent regardless of the time held.

The interest equalization tax is to be imposed on the gross amount of foreign securities purchased by U.S. persons. Table II shows the gross purchases of foreign stocks and bonds by U.S. persons from foreigners from 1950 through 1963. While the amount of securities purchased has fluctuated from year to year, bonds have usually accounted for the bulk. In 1963, bonds accounted for over 75 percent of the total gross purchase of foreign securities.

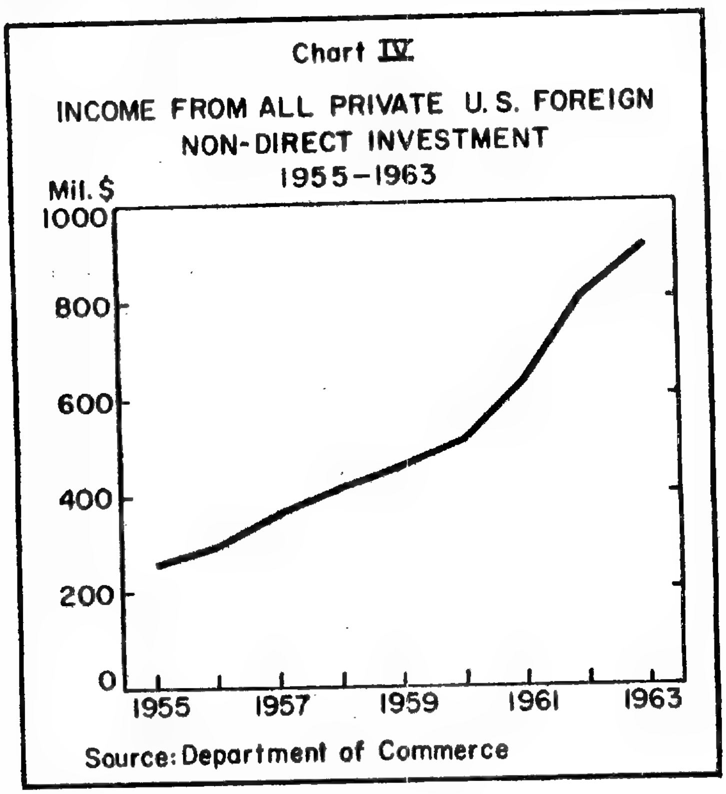


TABLE II.—*Gross purchases of foreign securities by U.S. citizens*

[In millions]

	Bonds	Stocks	Total
1950	$710.2	$198.2	$908.4
1951	801.0	348.7	1,149.7
1952	677.4	329.6	1,007.0
1953	621.5	303.4	924.9
1954	841.3	644.9	1,486.2
1955	409.4	877.9	1,287.3
1956	991.5	875.2	1,866.8
1957	1,392.0	621.9	2,014.0
1958	1,915.1	803.7	2,718.8
1959	1,457.6	803.8	2,261.5
1960	1,445.0	591.7	2,036.7
1961	1,262.4	965.6	2,228.0
1962	2,037.3	805.9	2,843.2
1963 [1]	2,086.0 (655.0)	644.3 (343.9)	2,730.3 (998.9)

[1] The figures in parentheses are the purchases that would have been subject to tax if the interest equalization tax had been law in 1963. The percent of purchases subject to tax would have been 31.4 percent for bonds, 53.4 percent for stocks, and 36.6 percent of the total.

Source: Treasury Bulletin.

If the tax had been law in 1963, $2.7 billion minus exemptions would have been affected. However, under the House-passed version, most of this $2.7 billion would have been classified as coming from less developed countries and international institutions, and thus exempt from the tax. Under the most optimistic assumptions, only a little over one-third or about $1 billion would have been subject to the tax. Even this latter figure is considerably overstated, however, because it includes purchases of stocks considered direct investments (purchaser owns over 10 percent of stock after the purchase) and bonds and stocks received in lieu of cash for payment of goods and services which would also be exempt.

Looking only at U.S. gross purchases of foreign stock gives only one side of the picture. If the sale of foreign stock is snuffed out in the United States, the flow of U.S. stock to foreigners will also be affected. Enactment of the tax will not only reduce the flow of foreign stock-seeking U.S. buyers, but foreign buyers seeking U.S. stock.

For example, comparison of the 8 months preceding the date the tax was proposed with the 8 months immediately following show a $100 million reduction in the net purchase of U.S. stock by foreigners.

This happens because foreign brokers and dealers unable to get reciprocal business will be less receptive to U.S. brokers and dealers attempting to sell U.S. securities in foreign markets. Maintaining these contacts for sales of U.S. stock abroad is critical to the U.S. payments position. U.S. stocks sold abroad are mostly from outstanding issues as opposed to newly issued equities, and thus require the participation of foreign brokers and dealers through regular channels.

To continue the sale of U.S. stock abroad, we must maintain a market for foreign stock in the United States. As table III shows the net flow of funds in stock transactions (U.S. purchases of U.S. and foreign stocks from foreigners less foreign purchases of U.S. and foreign stocks from U.S. citizens) has been favorable. Totals for 1950–63 show a favorable inflow of $150 million. Measured from 1958 when the serious payments problem developed, stocks still showed a favorable net inflow of $60 million. On the other hand, bonds have resulted in an outflow of funds for every year except 1955. For the years 1950–63, this outflow amounted to $6.1 billion; since 1958, it has been $4.6 billion. Thus, exempting foreign stocks from the tax would not stimulate an outflow of funds but could, in fact, prevent an outflow due to a decline in U.S. stock sales to foreigners.

TABLE III.—*Net foreign purchases of U.S. securities and U.S. net purchases of foreign securities (new and outstanding)*

[In millions]

Year	Stocks	Bonds	Total
1950	−$21.5	−$121.6	−$143.1
1951	+43.9	−322.2	−278.3
1952	−34.8	−170.4	−205.2
1953	+62.0	−63.7	−1.7
1954	−116.6	−42.7	−159.3
1955	−86.8	+212.6	+125.8
1956	+129.9	−349.7	−219.8
1957	+113.5	−641.8	−528.4
1958	−392.7	−1,008.8	−1,401.5
1959	+125.2	−439.4	−314.2
1960	+119.1	−512.0	−392.9
1961	−47.2	−559.7	−606.8
1962	+7.3	−995.3	−988.0
1963	+248.8	−1,086.1	−837.3
1st half	+62.2	−917.2	−855.0
2d half	+186.6	−168.9	+17.7
Total:			
1950–63	+150.1	−6,100.8	−5,951.7
1958–63	+60.5	−4,601.3	−4,541.8

NOTE.—(−) means an outflow of funds.

Source: Treasury Bulletin.

FUTURE OF CAPITAL MARKETS ABROAD

In the final analysis, it is development of capital markets in the rest of the world that holds real promise for improving our balance of payments. The development of capital markets outside of New York for long-term funds for foreign as well as domestic needs will also be helpful to others as balance-of-payments problems arise.

As Secretary of the Treasury Dillon said on May 21, 1964, before the 11th Annual International Monetary Conference: "* * * progress in improving the free world's capital markets has become essential if the uninhibited flow of long-term international portfolio capital is not to be a disturbing element in the quest for payments equilibrium."

Yet the very inclusion of stocks in the interest equalization tax means selling of all U.S. securities abroad will be more difficult. In short, the international roadways for trading securities, developing to expressway capacity during the last 10 years, will be reduced to country lanes with restricted traffic in both directions if this tax is passed.

Indirectly, enactment of this tax will hinder the development of equity capital markets abroad. It will cause a reduction in the number of U.S. securities brokerage houses and representatives abroad, and reduce the contact between United States and foreign securities representatives. Once the U.S. foreign selling offices and communications lines are reduced, chances for developing truly large international capital markets in foreign countries become more remote.

AN ALTERNATIVE TO THE INTEREST EQUALIZATION TAX

In lieu of the interest equalization tax, I recommend that Congress and the administration give full support to the recommendations contained in the Presidential task force report on the balance of payments. These recommendations are aimed at reducing the balance of payments over the mid term and long term as well as in the short run. The proposed tax, on the other hand, is at best a short-run measure and may seriously disrupt long-run opportunities to ease our balance of payments.

While there is no question that U.S. businessmen and Government officials will do their utmost to reduce the payments deficit, regardless of what happens to the tax proposal, their task would be much easier without it. As an indication of this kind of effort, the New York Stock Exchange this past April listed a Tokyo bond issue that was floated abroad. The exchange listed the $22½ million issue even though there were almost no initial purchases by Americans, because of the

general feeling that the issue could be sold more readily if listed. The basis for this feeling among members of the selling syndicate was the inadequacy of the foreign "aftermarket"—a market in which initial purchasers could sell if they decided to.

Many of the recommendations of the task force can be carried out without legislation. The securities industry and private businesses should be encouraged to promote activities and to operate in a manner consistent with reducing the payments deficit. Federal legislation is not needed to accomplish this objective. In fact, to adopt temporary palliatives in patchwork fashion may well be the least attractive and least appropriate of the alternatives available. In our view, the most attractive program would be to encourage in all ways possible the private sector of the economy presently engaged in and interested in international trade and finance to recognize their responsibilities and commitments to the balance-of-payments situation of this Nation in their business decisions.

To the degree that governmental legislation is required, action is centered in the tax area. New legislation is required here and should be considered as soon as practical.

PRESIDENTIAL TASK FORCE REPORT

Without detailing here the task force report's 39 recommendations, I shall summarize quickly the major areas that the task force believes hold promise for reducing our balance-of-payments deficit. If successfully carried through, the task force recommendations would—

1. Increase sales of U.S. corporate securities abroad.
2. Increase funds raised abroad for oversea operations of U.S.-based corporations.
3. Increase the flow of foreign funds to U.S. banks.
4. Speed up the pace at which foreign countries are reducing restrictions on international capital movements.

The task force found that our tax structure contained a number of elements "* * * which unnecessarily complicated and inhibited investment in U.S. corporate securities without generating material tax revenues." Specifically, changes in the estate taxes, capital gains taxes, and definitions of "engaging in trade or business" as they apply to foreign investors were thought to be highly desirable. This would clear away many of the uncertainties for foreign investors regarding their potential tax liabilities. These changes would not, however, turn the United States into a tax haven, nor drain funds from developing countries.

As President Kennedy said in his balance-of-payment message: "Securities of U.S. private firms could be and should be one of our best selling exports." The task force agreed with this statement and believed that added effort by the securities industries and U.S. corporations could increase the sale of U.S. securities to foreigners.

The exchange community has historically encouraged the sale of American securities abroad. Brokerage houses and investment banking firms that are members of the exchange have over 160 offices in 23 foreign countries. This is an increase of 125 offices since 1950. Also, the exchange is encouraging transmission of its ticker tape outside the United States. A number of installations have already been completed abroad, and further installations will be made as demand develops.

The remainder of the recommendations were directed at alleviating restrictions imposed on capital markets and international capital movements by foreign governments. The reasons for these restrictions vary but usually stem from exchange controls established for balance-of-payments reasons, the direction of domestic monetary policies, regulation of financial institutions, and attempts to enhance internal capital investment. Steps for improvement in these areas will in general require government-to-government agreements.

The task force recommended that the United States take the diplomatic initiative, bilaterally or multilaterally, for removal of exchange controls on capital transactions among advanced countries and the relaxation of monetary, legal, institutional, and administrative restrictions on capital movements. The State and Treasury Departments were urged to take up these and related problems with the appropriate international organizations, such as the International Monetary Fund and the Organization for Economic Cooperation and Development.

While removal of these restrictions by foreigners offers much hope for reducing the U.S. balance-of-payments deficit, the task force noted: "* * *

efforts to remove restraining influences on sales of U.S. securities to foreigners will raise in foreign financial markets the question of the continuation of the U.S. interest equalization tax as a factor affecting the sale of foreign securities to U.S. citizens, however temporary and special its basis."

Thus, an immediate effort on the part of Government and business—a joint venture if you like—to implement the task force recommendations would be more desirable and more effective than the proposed tax in solving our international payments deficit. The recommendations of the task force are positive steps that go to the heart of the payments problem. The tax, on the other hand, is a negative approach that moves against the tide for freer capital markets.

Speaking for myself, I believe the task force or a similar group could be the rallying point for coordinating the joint effort needed to put these recommendations into action. Such a group could be made an effective tool in solving the payments problems.

VOLUNTARY CAPITAL ISSUES COMMITTEE

Expanding on the principle of encouraging action by the private sector to help in the payments area, a voluntary capital issues committee could be established. Such a committee composed of representatives of the financial community involved in international finance, in cooperation with the Federal Reserve, could draw up and apply guidelines for screening foreign issues coming to the U.S. capital market. Because this market is centered in New York, the logical agency to work with the financial community is probably the New York Federal Reserve Bank.

Such a voluntary committee being free of direct Government control would not be unduly influenced by political considerations. The Federal Reserve Board operated a similar committee during the Korean war to control credit, and so there is precedent for such an approach.

Certainly it would be preferable to give the private sector an opportunity to try voluntary approaches such as the task force recommendations and/or the capital issues committee before the Government resorts to such a drastic measure as the interest equalization tax. If this does not prove effective within a reasonable period, then of course, Congress can review its decision.

RESTATEMENT OF RECOMMENDATIONS

1. The proposed interest equalization tax should not be passed. The tax, due to its retroactive provisions, has already largely served any useful temporary purpose it may have had. To pass the tax now would not be in the best interest of the United States and could retard the development of international capital markets.

Moreover, the proposed tax discriminates unfairly against stock issues relative to bonds or debt instruments. The net flow of funds in stock transactions among foreigners and U.S. persons has been favorable to this country. Inclusion of stock in the interest equalization tax at the rates proposed could eliminate or reduce this favorable funds flow. Thus, as a minimum, stocks should be excluded from the tax.

2. In lieu of the tax, the recommendations of the Presidential Task Force on the Balance of Payments should be implemented immediately. If successful, these recommendations would provide long-term as well as short-term improvement in the U.S. balance of payments.

3. If need be, a voluntary capital issues committee along the lines of that used during the Korean war crisis could be established. Such a committee composed of representatives of the securities community and Federal Reserve could establish and apply guidelines for screening proposed foreign issues.

STATEMENT BY SMITH, BARNEY & CO., INC., NEW YORK, N.Y., RELATING TO H.R. 8000, INTEREST EQUALIZATION ACT

Smith, Barney & Co., Inc., are opposed to the enactment of the Interest Equalization Act for the following reasons:

Conditions which prevailed a year ago have undergone substantial changes. Accentuation of adverse balance threatened has not developed and enactment of proposed bill is no longer necessary.

(1) A year ago there was concern abroad about the U.S. dollar. Since then the Federal Reserve bank has raised its discount rate by one-half of 1 percent, but there are ample funds available and interest rates have remained stable. Interest rates abroad have, however, been increased broadly in order to fight prevailing inflationary pressures. Our own price structure has been fairly stable. Swap and exchange arrangements have been entered into by the central banks. Our gold stock has declined from July 31, 1963, to June 17, 1964, only by $172 million, and some European bankers have recently forecast a growing demand for dollars. The U.S. dollar is strong today.

(2) The conditions prevailing a year ago, which motivated the interest equalization proposal, have undergone substantial changes and the need for adopting the proposed act, which was debatable then, no longer exists.

(3) A brief comparison of certain pertinent recent balance-of-payments figures follows:

[In millions of dollars, seasonally adjusted]

Balance of payments	1960	1961	1962	1963	1963, 1st 6 months	1963, 2d 6 months	1964, 1st quarter[1]
Deficit U.S. balance of payments, excluding military grant aid	3,881	2,370	2,203	1,942	1,870	72	42
Long-term private portfolio investments abroad	853	1,025	1,227	1,644	1,119	525	226
Including— Long-term private portfolio investments in Canada	171	259	332	532	493	39	47
Term bank loans and other long-term loans, excluding Canada (net)	282	273	295	580	197	383	236
Short-term loans abroad, excluding Canada (net)	1,135	1,053	389	788	219	519	356

[1] Preliminary.

These figures speak for themselves. While the total deficit shows a substantial improvement during the second half of 1963 and the first quarter of 1964, our long-term foreign portfolio investments decreased to a much smaller extent and our term bank loans and short-term loans abroad increased substantially after the interest equalization proposal was made a year ago. These latter loans and loans to Canada, which are listed above to show their magnitude, would not be subject to the interest equalization tax under the proposed bill.

Long-term dollar issues have been shifted from New York to London and the Continent and U.S. term bank lendings have in part taken their place.

(1) Because of the defaults on many foreign bonds during the early 1930's, the amounts of foreign securities sold in this country have always been relatively small. From 1958 to 1963 the public offerings of new foreign dollar bond issues, excluding Canada, World Bank, and Inter-American Development, have averaged about $211 million per annum and a sizable percentage (from 30 to 70 percent, depending on the case, and approximately 50 percent on the average) was resold in Europe. Sales of foreign securities in the United States during the 1950's and 1960's have at times been very slow. If we exclude Canadian, World Bank, and Inter-American Development Bank bond issues, sales of such foreign new bond issues amounted to only $336 million in 1962 and $277 million in 1963. Taking this into account, these are relatively small amounts with no important effect upon the balance of payments, particularly when it is realized that approximately half of this amount was taken abroad.

(2) As a result of the interest equalization proposal, New York has lost its preeminent position as the world's long-term foreign capital market. The London merchant bankers and some continental bankers quickly took over the offering of new foreign dollar long-term securities issues. As in the case of the Euro-dollar market, which they developed because the U.S. commercial banks were not permitted to pay comparative time deposit rates, they are now developing a new long-term Euro-dollar issue market at the expense of New York. Long-term public financing in Europe since the end of June 1963, may be estimated at about $350 million. This is a development unfavorable to the United States since the proceeds from foreign long-term loans in the United States often were used to purchase equipment and machinery in the United States. It has injured U.S. prestige abroad, has had practically no effect

on our domestic interest rates structure and in certain fields has diminished the purchase of U.S.-manufactured products which otherwise would have been purchased in the United States.

(3) Because the proposed bill exempts 3-year foreign loans made in the ordinary course of business by commercial banks, foreign borrowings from commercial banks have sharply increased. According to the Federal Reserve Bank Bulletin, at the end of 1962 commercial bank lendings abroad, excluding official institutions, were $1,595 million; at the end of the first 6 months of 1963 they were $1,568 million, and such loans by the end of February 1964 were $1,906 million, an increase of $338 million. These figures speak for themselves and clearly indicate that a sizable amount of long-term financing has simply been replaced by borrowings from commercial banks, which has not helped the balance of payments. In fact, the amount of short-term borrowings probably exceeds by a substantial margin the amount of long-term financings which might have developed but for the interest equalization proposal. This is a loophole which circumvents the intent of the interest equalization tax.

Proposed Treasury amendments help make the bill more workable but it will still be complex, involving much paperwork and its benefits will be small and disproportionate to its adverse effect.

Delay in passage of the bill has given the Treasury the opportunity to study the impacts of the proposed bill more carefully and the proposed amendments reflect this. They make the bill more workable but the bill is still complex and will require much redtape and unnecessary paperwork.

It is strongly suggested that the committee not endorse passage of the bill. Because of improvement in the balance of payments and sharp increase in bank term loans and proposed Canadian exemption the benefits obtainable from passage of the bill will be small and because changed conditions and restored faith abroad in the U.S. dollar, purposes of bill can be accomplished by continuous voluntary exchange of views with U.S. Treasury and Federal Reserve bank.

(1) In view of the improved climate, the increase in foreign term loans by commercial banks and the proposed Canadian exemptions the benefits obtained from the passage of the bill are small and it is suggested that the committee not endorse the passage of the bill. We believe that U.S. prestige in the international long-term capital markets will tend to be restored if the bill is not endorsed by the Senate.

(2) We believe that, in view of the small benefits obtainable through the passage of the bill, a continuous voluntary exchange of views between the Treasury and the Federal Reserve bank and the underwriters will, in the light of the changed conditions prevailing today, obtain substantially the same results as those obtainable under the proposed bill without the disabilities that are inherent in the bill. If this assumption should prove to be incorrect, corrective measures can be adopted at that time. We believe that voluntary cooperation with the Treasury and the Federal Reserve bank would work well and would be preferable to the restrictions of the proposed bill.

If the committee nevertheless endorses the bill, then consideration should be given to the special position of Japan.

Japan is the second best customer of the United States. In 1962, the Japanese bought $400 million more of our goods than we bought from them; in addition, they paid us $74 million in licenses and royalties. In 1963, their purchases from us exceeded their sales to us by $570 million. From 1959 to 1963, their purchases exceeded sales to us by $2.5 billion. Japan is our political ally in the Far East and a most-important military outpost.

The Japanese need foreign long-term borrowings for a few more years in order to balance their adverse balance of payments. U.S. short-term loans to Japan by the commercial banks exceed the gold and foreign exchange of the central bank, the Bank of Japan. It is important for the position of our banks and for Japan to fund some of this short-term indebtedness as soon as possible. Japan has been able to issue some long-term bonds in Europe during the last 12 months but the European interest is limited; it is much narrower than that in the United States. The amounts involved are not very large. In 1962, the long-term new issues obtained by Japan in the United States amounted only to $101 million and during 1963 to $140 million.

Under these circumstances we urge that, if the bill is endorsed by the committee, it requests the Treasury to give Japan a full or a limited exemption as in the case of Canada.

SMITH, BARNEY & CO., INC.

TOKYO, *July 3, 1964.*

Senate Finance Committee, Washington, D.C.:

Re hearings on interest equalization tax. Respectfully request that committee consideration be given to real cause of payments deficit which is not purchase by U.S. citizens of foreign securities which actually produce a return far greater than outlay and gives the United States a stake in foreign business the end effect of which also includes increased U.S. exports. Also please consider that Canada exclusion practically negates purpose of bill and discriminates against Japan which is the second largest importer from United States. If Secretary Dillon thinks reaction in Japan "not too serious" suggest he confer with Secretary Hodges who is familiar with Japanese situation. The bill even in proposal stage has created a European capital market that did not exist, the effect of which can only work to detriment of U.S. interests. Also please consider tax effect on U.S. citizen resident abroad who must pay tax in dollars on purchases of foreign securities in foreign currency from earnings in foreign currency which has absolutely no effect on U.S. balance of payments. We believe that proposed bill imposes restrictions inconsistent with longstanding U.S. policy of free capital movement and should be rejected.

A. LEWIS BURRIDGE,
President, American Chamber of Commerce in Japan.

NEW YORK, N.Y., *July 2, 1964.*

Re H.R. 8000, interest equalization tax.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: We respectfully request your consideration of the provision for imposing the proposed interest equalization tax on purchases of non-U.S. securities by U.S. citizens resident abroad on a permanent basis.

While the number is not great, there are many U.S. citizens who live in foreign countries and who earn their livelihood there. As we expect of aliens permanently residing in our country, these U.S. persons are expected to be "good citizens" in the country of their residence. We need hardly say to you that the presence of U.S. citizens abroad is of great advantage to the U.S. international position, in promoting trade and showing our presence throughout the world. In many cases it is normal for such nonresident citizens, and indeed it is expected in the communities in which they live, to invest their savings from earnings in local enterprises. To do otherwise would make it appear to their associates that they have little interest in the welfare of the countries they live in. Nevertheless H.R. 8000 as before your committee requires that these citizens pay a penalty tax on purchases of non-U.S. securities regardless of the fact that the funds for such purchases may be derived from earnings from services in the foreign country, received in foreign currency.

The stated purpose of H.R. 8000 is to inhibit the outflow of funds from the United States so as to alleviate the balance-of-payments problem. Investments by nonresident U.S. citizens of funds earned abroad do not affect the U.S. balance of payments. Thus the imposition of this tax on such nonresident citizens appears entirely beyond the purpose of the act.

This matter was drawn to the attention of the Ways and Means Committee but it was not recognized in the bill reported by the House. Neither is it recognized in the suggested amendments submitted to your committee by the Treasury Department.

Perhaps the Treasury Department was concerned about the administrative problems which it would encounter if an exemption was provided for investments by U.S. citizens abroad from foreign-source earnings. However, it should be recognized that under present law such U.S. citizens have to report to the Internal Revenue Service the entire amount of their earnings including the portion which is exempt from U.S. tax. Thus it appears to us that there would be no great difficulty in devising a procedure by which such nonresident citizens could identify purchases of securities of foreign corporations which are made from foreign-source earned income. As a matter of fact, to secure compliance with the act in the form now before you, it would appear necessary that a procedure based on income reporting be followed in any event so that such nonresident citizens will be required to report their purchases in foreign markets of foreign securities, since there appears to be no practicable way to require

foreign exchanges or security dealers to report such transactions to the United States.

Thus it appears that equitable treatment of these U.S. citizens in the manner we suggest would not only relieve them of an unwarranted burden with no relation to the stated purposes of the act, but would also provide a ready means for determination of the tax due by them on security purchases which do affect the U.S. balance of payments.

Yours very truly,

PRICE WATERHOUSE & CO.

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., June 30, 1964.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the Machinery and Allied Products Institute, a national organization of capital goods and allied product manufacturers, we are filing this statement of the institute's views on H.R. 8000, "Interest Equalization Tax of 1963" and we would appreciate having it included in the record of the committee's hearings.

This statement is not presented in direct opposition to H.R. 8000 but rather to raise some questions which we believe deserve the committee's most thoughtful study. The interest equalization tax is a novel and farreaching proposal both in terms of American investment abroad and U.S. tax policy. Although suggested as a temporary means of coping with what is—hopefully—a transitory balance-of-payments problem, the principle which it embraces is of much longer range significance. It is our purpose here to suggest a consideration of this proposal against a broader backdrop of related events. More specifically, we intend, first, to call the committee's attention to a clearly developing pattern of U.S. Government control over American private investment abroad and the fact that the proposal's adoption would leave us but a short distance from a system of complete control over foreign investment; second, to consider the efficacy of the interest equalization tax as a specific cure for the balance-of-payments malady; and third, to comment briefly on certain technical amendments now recommended by the Treasury.

Certainly we are aware of the country's balance-of-payments problem and we are not unsympathetic with the Treasury's motives in advancing the interest equaliation tax proposal. Nevertheless, we believe that the proposal presents for the committee's consideration this fundamental question of policy: Once we undertake to limit the freedom of capital movement and embark upon the path of control, once we decide to substitute governmental for private judgment respecting foreign investment, is there any turning back?

In order fully to appreciate the significance of the interest equalization tax in this light it becomes necessary to consider briefly the developing framework of control over American investment.

Partial control of equity investment abroad

The Revenue Act of 1962 included a series of new provisions relating to the direct taxation of foreign earnings. As in the present case these provisions were originally suggested for the purpose in part of limiting American private investment abroad and thus improving our balance-of-payments position. The result has been to impose, albeit indirectly, a control on equity investment; H.R. 8000 would appear to complement the foreign earnings provisions of the Revenue Act of 1962 by imposing a control on portfolio investment abroad. The new burden of direct taxation was laid only on certain earnings of investments in so-called developed countries while the deferral of U.S. taxes hitherto permissible in the case of most foreign income was continued in the case of the yield from investments in so-called underdeveloped countries. It can be argued, of course, that the reason for thus burdening one kind of investment and not burdening another was to induce the flow of private investment into underdeveloped countries, thereby reducing the foreign aid burden on our international balance of payments. As a long-run matter this may have some merit but in the short run we see little evidence that it is producing the desired results.

Partial control of portfolio investment

As noted above, the proposed interest equalization tax would complement the foreign earnings provisions of the Revenue Act of 1962 by applying to portfolio rather than equity investment. However, like those statutory provisions the current proposal distinguishes between developed and underdeveloped countries and exempts from the application of the proposed tax securities of underdeveloped countries or their nationals. In addition, it would empower the President to exempt other individual security issues from the application of the tax where, in his judgment, this is required for purposes of international monetary stability. Although the Treasury has announced that such exemption authority is to be exercised only with respect to Canadian securities, the exemption may well be applied more broadly in the future. Nevertheless, H.R. 8000 clearly adopts the principle of controls over portfolio investment in foreign securities.

Will the interest equalization tax work?

Assuming the necessity of the interest equalization tax as a means of assisting and correcting the imbalance in our international payments account, one is confronted immediately with the practical question of whether or not such legislation would serve the purpose for which it is intended. Beyond doubt the investment of American capital in foreign securities has been sharply reduced as a result of the threat of congressional adoption of the interest equalization tax. Thus, the proponents of the bill may argue that H.R. 8000 has already demonstrated its effectiveness. This is, of course, without taking into account the possibility of counteraction by foreign governments adversely affected by this measure or the longer range effects of such action on the level of our foreign trade.

The fact that the apprehensions raised by the possibility of an interest equalization tax have served temporarily to improve our balance-of-payments position is by no means a conclusive demonstration that the proposal would have the same effect when and if finally enacted. Once the uncertainty of a legislative proposal is replaced by the certainty of congressional enactment, we suggest that the money market will readjust promptly to the realities of the new situation and that the long-range effects may be relatively insignificant.

One thing seems certain. During the pendency of the bill a very substantial backlog of foreign issues has been withheld from the American capital market. However, "Europeans have hesitated" says a Christian Science Monitor story of May 29, 1964, "because of the uncertainty of the legislation, not because of its punitive rate." As a result, we are inclined to think that the bill's adoption may lead to at least a temporary worsening of our balance-of-payments situation in the short run and have a relatively small total effect in the longer run. Worse yet, according to the same Christian Science Monitor story noted above, it may introduce a kind of Gresham's law of capital issue flotation into the American market by driving out the foreign blue chips but in no way deterring issues of less worth. "Top firms [from Europe]" says the Monitor, may find it cheaper to float issues elsewhere. Consequently, it will be the American investor that may suffer from the Treasury's proposal. Not only will he be deprived of better foreign paper, but he will be faced with second-class companies."

If we are correct in believing that this proposal may not produce any substantial long-term impact on our balance-of-payments positions, then it seems logical to assume that the Government——having once chosen the control route—will cast about for other and sterner measures of control. Having already imposed a new restraint—through the Revenue Act of 1962—on the investment abroad of equity capital, it is proposed by H.R. 8000 to impose a partial control on portfolio investment. The interest equalization tax as presently proposed would impose a tax of about 1 percentage point on foreign securities. If it were adopted and failed to do the job, would the next step be to increase the rate? Or would the Government be prepared to establish total control over all foreign investment of American capital—both equity and portfolio?

As an alternative to the present proposal it has been suggested—and to the Treasurys great credit, in our judgment, it has rejected the alternative—that there be established "A capital issues committtee operated by the Treasury and the Federal Reserve." In plugging for such a committtee a New York Times editorial of Thursday, June 25, stated that "it could be used also to regulate direct investment by American corporations, which accounts for a large part of the outflow but is not affected by the proposed tax."

In the light of all the possibilities which this proposal raises, we think the Finance Committee should consider if it is desirable to take the further step that is here proposed on the road to a system of overall capital control.

The temporary character of this legislation.—As now drafted the interest equalization tax would expire December 31, 1965. Certainly, if Congress were to adopt H.R. 8000 we strongly favor its being made only temporary in character. We have no doubt of the Treasury Departments sincerity in assuming that the need for the interest equalization tax—in view of our rapidly improving balance-of-payments situation—will have disappeared by the end of 1965 and that the proposed legislation may then be permitted to expire. However, certain questions remain which, in our judgment, desire the comimttee's most careful consideration.

First, we should not overlook the record of "temporary legislation' adopted in the past and the tendency which such legislation has to become quasi-permanent in character. Two current examples will serve to illustrate the point. Congress is even now in the process of extending yet again a wide variety of excise taxes adopted in wartime and it also has extended for the seventh time the "temporary" Renegotiation Act of 1951.

Of great importance also, in our judgment, is the fact that adoption of H.R. 8000, even on a temporary basis, will represent legislative approval of the principle of controlling the flow of capital. This we think a potentially dangerous step fraugt with unforeseen and unforeseeable consequences. As numerous witnesses argued in hearings before the House Ways and Means Committee on H.R. 8000, industrial nations affected by our interest equalization tax have available to them a wide range of possible counteraction, the initiation of which may require in turn a continuation and enlargement of the pattern of capital control called for by this measure. In short, by adopting a temporary measure we may set in motion a train of consequences requiring similar——and more stringent—action of a permanent character.

Perhaps more important is the probability that the effects of H.R. 8000 will be considerably less beneficial than the threat of their adoption has been—in short, the likelihood that the interest equalization tax may not prove a wholly efficacious remedy—and that the "temporary" character of this measure will give way to the more stringent controls suggested above.

Technical amendments

Inasmuch as we are opposed to adoption of the general principle of capital control, it naturally follows that we favor limiting any application of that principle which Congress may deem necessary as a temporary expedient in the present circumstances. Accordingly, we endorse the series of liberalizing amendments to H.R. 8000 proposed by the Treasury Department and transmitted to the chairman of the committee by Secretary Dillon's letter of June 12. Certain of those amendments deserve brief mention.

We are especially pleased to note that Secretary Dillon's general explanation and suggested amendments make perfectly clear that the proposed tax is not intended to interfere in any way with the legitimate export financing of U.S. goods and services. In its original form, H.R. 8000 left some doubt as to whether or not the exemption from the tax's application would extend to the export of services as distinguished from the export of products.

We are also gratified by the Treasury's proposal for amendments relating to "certain interests in intangible personal property" (appearing at pp. 10–11 of the committee print, "Amendments recommended by the Treasury Department to H.R. 8000, interest equalization tax"). As noted in our statement on this bill to the House Ways and Means Committee, some U.S. companies for various reasons find it desirable to develop an equity interest in manufacturing licenses abroad and for that purpose to take equity shares in lieu of cash under royalty arrangements written into the contract. If a company pursuing this practice had an equity position of less than 10 percent its further investments would have been subject to the tax under the bill as originally written. We are pleased to note their specific exemption.

Finally, we should like to call attention to a revision of H.R. 8000 accomplished by the House Ways and Means Committee which we fully endorse and in which capital goods and allied product manufacturers are particularly interested. The House amended H.R. 8000 to exclude from the interest equalization tax certain so-called "turnkey" projects where an equipment (or other) manufacturer enters into a contract with a buyer under the terms of which the contractor finances the entire project including goods and services of other suppliers. The original bill, while excluding from the tax the obligations acquired by a U.S. contractor in connection with his own exports, would not have excluded obligations acquired by the contractor for goods or services actually

84-937—64——22

exported by the other suppliers involved in the project. Under the House bill, subject to certain conditions, an obligation acquired in connection with turnkey project would be exempted from application of the tax. We endorse the liberalizing change made by the House.

This concludes our statement on H.R. 8000, the Interest Equalization Tax Act of 1963. We would appreciate the inclusion of this statement in the record of these hearings.

Respectfully,

CHARLES W. STEWART, *President.*

INTERNATIONAL HOLDINGS CORP.,
New York, N.Y., July 2, 1964.

Re H.R. 8000.

Hon. HARRY F. BYRD,
Senate Finance Committee, U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: This corporation opposes enactment of the so-called interest equalization tax on the ground that it will seriously set back the position this country has achieved as the financial center of the world.

If, however, your committee feels the bill should be enacted, this corporation urges that your committee give consideration to the special circumstances of investment companies such as ours, and permit such companies to reinvest the proceeds of sales of foreign securities in other foreign securities free of tax.

International Holdings Corp. is a Maryland closed-end investment company whose shares are listed on the American Stock Exchange and the Stock Exchange, London. It has been the policy of our management, and that of its predecessor companies over a long period of years, to maintain about 25 percent of the assets of the fund in foreign securities. The continuance of this policy would not affect adversely the international position of the U.S. dollar.

The proposed tax will discriminate against the company and discourage foreign ownership, which is surely not the purpose of the proposed legislation. There would be no dollar drain as a result of its being permitted to continue its long-standing policy of investing and reinvesting, free of tax, its foreign portfolio within its present limits.

Approximately 80 percent of the company's own capital stock is held in foreign names, and, the funds with which the company works were derived from foreign sources. Six of the company's twelve directors are nonresident aliens.

We urge that the bill be amended to permit investment companies with more than, say 66⅔ percent of their stock held abroad, and with a consistent history of holdings of foreign securities, to reinvest the proceeds of sales of foreign securities in other foreign securities free of tax.

History and investment policy

International Holdings Corp. is the outgrowth of two Canadian investment companies, predecessors of which were formed by European interests in the 1920's. When the company was formed in 1958 and its assets brought here from Canada, there was a net gain to the U.S. economy.

The company's policy with respect to foreign investment is set forth at page 4 of its 1962 annual report as follows:

"International Holdings Corp., like many other closed-end U.S. investing companies, characteristically offers a means of participating in a widely diversified portfolio of domestic common stocks.

"It differs from most other funds, however, in that it includes somes foreign issues, principally in the British Commonwealth and continental Europe. The board's policy has been to keep investments outside North America to about a quarter of the net assets and the board has no present intention of altering this policy. The board maintains an attitude of complete flexibility about the com-

position of the portfolio and may vary the proportion of bonds, and other evidences of debt, preferred stocks, and common stocks, and may vary the proportion of investments within and outside of North America in accordance with its judgment concerning the economic and market outlook. For example, the board may, from time to time, find it appropriate to be significantly more, or less, fully invested in equities."

A copy of the 1963 annual report is attached for your information.[1]

We enclose herewith attachments A and B as schedules showing the amounts of the United States, Canadian, and other foreign securities held by the company and its predecessor companies from 1941 through December 31, 1963. It will be observed that the holding of foreign investments is the result of longstanding policy. In no sense do these foreign investments result from a temporary shift from U.S. securities. To penalize the company for reinvesting in foreign securities would seriously interfere with its investment activities.

While the relative percentages of the company's aggregate holdings in foreign securities have remained reasonably stable, there have been substantial swings as between investments in different foreign countries. For example, as of December 31, 1961, French securities constituted 2.2 percent of the portfolio and had a market value of $1,540,711. As of December 31, 1963, they had been reduced to 0.15 percent and $109,231, respectively. On December 31, 1961, the company had no Spanish securities. We then decided that the Spanish securities market offered interesting investment opportunities and built up the Spanish portfolio to 1.9 percent of the total portfolio with a market value of $1,189,349, as of April 30, 1962. We have recently been withdrawing from the Spanish market and Spanish holdings have been reduced to 0.6 percent of total portfolio with a market value of $445,833 as of December 31, 1963.

The company's investment adviser, Schroder Trust Co., is, we believe, peculiarly well fitted to provide a combination of advice on both U.S. and foreign securities because it is under common control with J. Henry Schroder Wagg & Co., Ltd., a long-established merchant bank of London, and thus has access to well-informed sources of information on foreign securities.

Effect on foreign shareholders

We believe that our stock is attractive to foreign investors because the company is and always has been an international investment company. If the proposed tax makes it impractical to retain this character, the company's own stock may become less attractive to its foreign shareholders. The shareholders might find it desirable to transfer the company to another jurisdiction or to sell their holdings to U.S. citizens. In either event our balance-of-payments position would be adversely affected.

Conclusion

We respectfully submit that to make an exception of funds similar to ours would not be contrary to the expressed purposes of the bill.

Because of the company's longstanding international character and its predominantly foreign ownership, an exception should be made in the proposed bill which would have the effect of allowing investment companies 66⅔ percent or more of whose stock is held abroad to reinvest in foreign securities the proceeds of foreign securities sold.

To do otherwise would be to penalize foreign shareholders for doing indirectly through a company incorporated in the United States what they can do directly themselves.

Very truly yours,

B. ALDEN CUSHMAN,
Vice President.

[1] 1963 annual report made a part of the committee files.

ATTACHMENT A

INTERNATIONAL HOLDINGS, LTD.

Analysis of portfolio by currency

[In thousands of Canadian dollars]

Dec. 31—	U.S. dollars		Canadian dollars		Sterling and other		Total
	Amount	Percent	Amount	Percent	Amount	Percent	
1941	$4,504	43	$4,335	41	$1,653	16	$10,492
1942	5,094	42	5,264	43	1,779	15	12,137
1943	6,125	46	5,086	39	2,001	15	13,212
1944	4,972	40	5,174	41	2,408	19	12,555
1945	8,602	52	5,532	33	2,543	15	16,677
1946	7,400	49	5,235	34	2,648	17	15,283
1947	7,654	47	5,418	34	3,116	19	16,188
1948	7,317	45	5,901	37	2,880	18	16,098
1949	8,894	55	5,081	31	2,297	14	16,362
1950	9,849	56	5,526	31	2,365	13	17,740
1951	10,428	58	4,963	28	2,493	14	17,884
1952	11,206	60	5,616	30	1,979	10	18,801
1953	11,143	60	5,261	29	1,944	11	18,448
1954	15,019	62	6,074	25	3,132	13	24,255
1955	17,247	61	6,615	23	4,659	16	28,521
1956	17,442	61	7,110	25	4,044	14	28,596
1957	16,536	63	6,357	24	3,346	13	26,239

TRANSFERS MADE DURING ABOVE YEARS BETWEEN SECTIONS OF PORTFOLIO

Year	Amount	Transferred from—
1952	$550,000	Canadian dollars to U.S. dollars.
1953	50,000	Pounds to U.S. dollars.
1954	550,000	U.S. dollars to pounds.
1955	661,669	Do.
1956	140,244	Do.
	109,456	French francs to U.S. dollars.
1957	96,675	Pounds to U.S. dollars.

NOTE.—It should be noted that the figures for the Canadian holdings of International Holdings, Ltd., are affected by its ownership of about 40 percent of the preferred stock of Hydro-Electric Securities Corp.

HYDRO-ELECTRIC SECURITIES CORP.

Analysis of portfolio by currency

[In thousands of Canadian dollars]

Dec. 31—	U.S. dollars		Canadian dollars		Sterling and other		Total
	Amount	Percent	Amount	Percent	Amount	Percent	Amount
1941	$5,418	55	$367	4	$4,068	41	$9,853
1942	5,698	50	1,091	10	4,478	40	11,296
1943	7,859	54	1,453	11	4,969	35	14,001
1944	9,006	57	1,023	7	5,661	36	15,690
1945	11,819	62	1,261	7	6,038	31	19,118
1946	10,235	60	1,398	8	5,463	32	17,096
1947	10,189	58	1,451	8	5,921	34	17,561
1948	10,083	60	1,410	8	5,291	32	16,784
1949	12,850	71	1,330	7	4,026	22	18,206
1950	13,605	73	1,276	7	3,722	20	18,603
1951	14,208	76	834	4	3,735	20	18,777
1952	14,858	81	168	1	3,299	18	18,325
1953	15,269	82	94	1	3,230	17	18,593
1954	20,483	81	[1] 113		4,745	19	25,341
1955	21,948	75			7,181	25	29,129
1956	21,712	77			6,569	23	28,281
1957	21,711	83			4,585	17	26,296

[1] Less than 0.5 percent.

TRANSFERS MADE DURING ABOVE YEARS BETWEEN SECTIONS OF PORTFOLIO

Year	Amount	Transferred from—
1950	$185,548	Pounds to U.S. dollars.
	16,797	Canadian dollars to U.S. dollars.
1951	81,993	Pounds to U.S. dollars.
1952	1,100,515	Canadian dollars to U.S. dollars.
1953	175,000	Pounds to U.S. dollars.
	77,493	Canadian dollars to U.S. dollars.
1954	392,970	U.S. dollars to pounds.
1955	1,121,851	Do.
1956	780,000	Do.
	153,455	French francs to U.S. dollars.
	4,389	Canadian dollars to U.S. dollars.
1957	1,452,468	Pounds to U.S. dollars.
	140,793	French francs to U.S. dollars.

ATTACHMENT B

Market value of portfolio securities

[Expressed in U.S. currency]

Date	Foreign		United States		Total
	Amount	Percent	Amount	Percent	
June 30, 1959	$14,604,983	23.4	$47,876,641	76.6	$62,418,624
Dec. 31, 1959	19,899,448	29.6	47,296,262	70.4	67,195,710
June 30, 1960	17,623,341	27.9	45,672,919	72.1	63,296,260
Dec. 31, 1960	18,165,515	28.5	45,531,066	71.5	63,696,581
June 30, 1961	18,227,331	26.8	50,076,925	73.2	68,304,256
Dec. 31, 1961	18,146,773	25.4	53,112,795	74.6	71,259,568
June 30, 1962	14,987,587	26.1	42,178,421	73.9	57,166,008
Dec. 31, 1962	15,219,607	24.1	48,009,073	75.9	63,228,680
June 30, 1963	17,465,794	23.6	56,508,854	76.4	73,974,648
Dec. 31, 1963	18,046,091	23.2	59,635,889	76.8	77,681,980
Average	17,238,470	25.8	49,589,884	74.2	66,828,354

STATEMENT BY MORGAN STANLEY & CO., NEW YORK, N.Y.

Morgan Stanley & Co. is a member of the Investment Bankers Association of America and fully endorses both the oral and written statements made before this committee by that organization. In the interest of time we have not requested time to testify orally. We are, however, filing this statement to set forth our own views on certain of the questions raised by the proposed interest equalization tax.

1. Introduction

The firm of Morgan Stanley & Co. is deeply concerned with our country's balance-of-payments deficit. However, it is our considered judgment that the attempt to limit new issues of foreign securities by means of the proposed interest equalization tax is not an appropriate solution to this problem. We share the administration's reluctance to impose exchange controls or limit the free flow of capital, but in our opinion the so-called interest equalization tax is a long step in that direction. At best, after allowance for the many proposed exemptions, the tax would appear to be of dubious effectiveness in limiting the outflow of dollars. At worst, the tax will not only limit the free flow of capital but also of trade with the rest of the world. In our judgment the tax will not over the long term materially help our balance-of-payments problem, and is dangerously liable to impair the financial mechanisms that have been carefully developed for supporting and strengthening our favorable balance of trade.

2. Background—The foreign securities market in the United States

(*a*) *Experience of Morgan Stanley & Co.*—Morgan Stanley & Co. is primarily engaged in raising new capital through the underwriting and distribution of new issues of stocks and bonds for American business enterprises. In addition to our work for American corporations, we have acted for a number of foreign governments and foreign corporations in financing their capital requirements. Governments for which we have managed or comanaged issues since World War II have included those of Australia, Belgium, Canada, France, and Italy. We have also arranged financing for corporations in certain of these countries as well as in Germany, the Netherlands and the United Kingdom. In addition, we have served as comanager of offerings of bonds in the United States by the International Bank for Reconstruction and Development. During the postwar period from January 1946 to the present, Morgan Stanley & Co. managed or comanaged public offerings and private placements of new issues of bonds and stocks amounting to about $20 billion, of which about 80 percent were for American corporations, 6 percent for the World Bank, 7 percent for foreign governments (of which 3 percent were Canadian) and 7 percent for foreign corporations (of which 3 percent were Canadian).

(*b*) *Postwar development of foreign financing in the United States.*—The years following World War II were characterized by a worldwide need for hard currencies to restore ruined economies to production. To supplement the

activities of the International Bank for Reconstruction and Development, the International Monetary Fund and the U.S. foreign aid programs our Treasury and State Department encouraged the private commercial and investment banking system in this country to raise dollars for foreign countries through bank loans and the public and private sale of foreign securities.

The reestablishment of a market for foreign securities in the United States after World War II, however, was a long and difficult process. Although Canada was able to resume borrowing without difficulty, and although Australia, The Netherlands, and Norway were able to market dollar issues in 1946 and 1947 to refund maturing debt or to finance capital goods imports from the United States for reconstruction, the private foreign securities market in the United States was for all practical purposes dormant until the end of 1954. The International Bank for Reconstruction and Development, beginning in 1947, did obtain the greater portion of its funds through public issues in the United States, selling $785 million of bonds by the end of 1954. To this extent private American and other investors contributed greatly to the building of the postwar world. However, this was through the medium of an international institution strongly backed by the U.S. Government, and investors were not yet ready to commit their money directly to foreign investments.

During this period, we and other investment banking firms were using our best efforts to develop interest in foreign securities. Progress was slow, particularly in the case of financial institutions. (In New York, for example, it was not until 1956 that life insurance companies were authorized by law to invest in foreign securities, and then only to the extent of 1 percent of their assets.) In the early years a market for securities of the World Bank itself had to be developed, and our firm together with the comanager of the financing conducted over a period of several years an extensive educational campaign, making personal calls on hundreds of institutional investors, supplying them with studies and arranging visits by them to the Bank itself. In some World Bank issues in an endeavor to broaden the market we set aside a portion of the issue expressly for sale to new buyers. In some of the early foreign government issues we offered a public issue of a country simultaneously with a loan to that country from the World Bank, which gave the investor an added element of confidence and eased the transition from World Bank financing to private financing. In the case of two governments, Belgium and Italy, we organized at our own expense tours of these countries by groups of institutional investors.

In December 1954 Morgan Stanley & Co. brought to market a $25 million public issue of bonds of the Commonwealth of Australia and comanaged a $30 million issue for the Kingdom of Belgium. Both countries had been large borrowers from the World Bank, and the successful marketing of these issues by investment bankers to private investors marked the real reopening of the foreign bond market. From this point on, institutions and other private investors in increasing numbers began to participate in foreign issues and thus to share the burden of foreign financing with the World Bank. The next several years saw additional Australian and Belgium issues as well as public issues for Norway, South Africa, the European Coal and Steel Community, New Zealand, Austria, Denmark, Japan, Italy, France, and others. In the last few years a small number of leading foreign corporations have also found it possible to sell securities in the U.S. market.

A notable exception to the general difficulties in reentering the U.S. market was the experience of Canada. The Government of Canada, Canadian provinces and Canadian corporations have all been able to sell securities here without difficulty, and during the period from the beginning of 1946 to June 1963 about 54 percent of all foreign issues (including those of the World Bank) have been for Canadian issuers. This was the result of a number of factors, including the geographical proximity of the country, the largely common language, the similarity of business and financial customs, the soundness, of the Canadian currency and, most important of all, the immense volume of trade between the two countries over a long period of time.

(c) *Role of the international capital market in the United States.*—It has been said that foreign nations should strive to develop their own capital markets and thus reduce their reliance on ours. We heartily support the objective of free and unrestricted capital markets of ample capacity in the leading developed countries. However, substantial progress has already been made toward this end, and we think that it can be accomplished without unnecessary damage to our own standing in the field of international finance. There are signs that if

the United States is too long inhibited from playing its former role as banker to the world, its position of preeminence may be very difficult to regain.

What are the factors that have made the United States the leading capital market of the free world? The primary one is the medium in which it deals, a sound currency, free of restrictions, enjoying complete confidence and constituting the principal reserve currency of the nations of the free world. Of almost equal importance has been the accessibility of the U.S. market to all who wished to make use of it, with no priorities and no restrictions on the size or frequency of issues other than the limitations of the market itself. An important additional factor is that interest rates in this country are substantially lower than in most other countries. To this may be added the size and wealth of our Nation, generating savings at a rate unapproached elsewhere in the world. And high on the list would be the advanced development of our techniques for mobilizing these savings for productive investment, including the highly organized investment banking industry, with firms operating in every State of the Union. Over 17 million Americans are direct stockholders and several times that number own securities indirectly through our multiplicity of insurance companies, savings banks, and other financial institutions. Factors contributing to this breadth of ownership are the wide availability of information on all types of investments and our standards of full disclosure of all material facts relating to new issues as prescribed by the Securities Act—standards that must be met by foreign as well as domestic issuers in our market. The results are low costs of issue, an active trading market, and a degree of liquidity that has not been approached in Europe or elsewhere in the world.

3. Characteristics of foreign financing

We believe that there are several important characteristics of foreign financing which are elements of strength for the long-term stability of the dollar and the favorable balance of trade of the United States. A study of foreign issues managed or comanaged by our firm since World War II brings out the following points which we believe are significant in considering the impact of these issues on the balance of payments of the United States:

(*a*) The government issues have been those of countries which are major trading partners and military allies of the United States. The corporate issues have been for prime corporations whose activities are important to the development of their countries. The bulk of the government and corporate issues have originated in countries that have made material contributions to this country's favorable balance of trade. Funds borrowed privately here help to strengthen the economies of these countries and in many cases generate the capacity to purchase American exports.

(*b*) In many of these issues all or a substantial portions of the proceeds were spent in this country and to this extent did not adversely affect the balance of payments. A number of others have been refundings of issues sold previously in the United States or of bank loans incurred in the United States, and thus represented no outflow of funds.

(*c*) A substantial portion of the public issues have been sold abroad, and to this extent represented no drain whatsoever on the balance of payments. In the many instances where the proceeds were spent in the United States this meant an actual inflow of funds into this country.

(*d*) The issues have been characterized generally by strong sinking funds, many retiring virtually all of the issue in advance of maturity and thereby materially accelerating the return of the funds to this country.

(*e*) The interest rates have been high by comparison with domestic rates, and the return thus earned is a favorable element in our balance of payments.

4. Proposed interest equalization tax

(*a*) *Effectiveness.*—After allowance for the exemptions proposed for Canada, the World Bank, the Inter-American Development Bank, the Export-Import Bank, the developing countries, bank loans, obligations of under 3 years' maturity, direct investments, and obligations arising out of export transactions, not to mention a variety of exemptions to cover various special situations, the remaining transactions to which the tax would apply would not be substantial in amount. It should be noted that 62 percent of the volume of new foreign issues purchased by U.S. persons in the first half of 1963 were Canadian issues. After taking into account the Canadian exemption and the many other proposed exemptions, we do not believe that imposition of the tax will result in a material long-range reduction in our balance-of-payments deficit. Indeed, the tax thus

far appears to have affected the form rather than the amount of capital outflow, as borrowers have turned to alternative methods of raising capital in the United States.

The sharp rise in short- and long-term bank loans since announcement of the tax is a matter of record. This increase has largely offset the decline in portfolio outflow. In fact, to the extent that foreign dollar bond issues have been replaced by bank loans, the balance-of-payments impact has actually worsened, since a substantial portion of bond issues are normally purchased by foreigners, while commercial bank loans represent a 100-percent outflow of capital.

In addition, we believe that the magnitude of the problem in the 6 months prior to announcement of the tax may not have been properly evaluated. The Treasury has stated that new issues of foreign securities purchased by U.S. persons in the first half of 1963, aggregating $999 million, were at a seasonally adjusted annual rate of about $1.9 billion. In our opinion it is not proper to use this first-half figure to calculate an annual rate, as certain of the larger transactions were extraordinary items and since quarterly results usually show wide fluctuations.

The figures for the first half of 1963 include, for example, half of a $250 million issue for the Government of Canada which was actually sold in 1962. This was the Canadian Government's first borrowing in this country in 12 years and was part of an emergency program participated in by the Federal Reserve System, the International Monetary Fund, the Export-Import Bank, and others to help Canada overcome a serious drop in reserves. The figures for Canada in the first half of 1963 also include half of a $300 million issue for the Province of Quebec, which was another extraordinary transaction the proceeds of which were used to finance the purchase by the Province of privately owned power companies.

In addition to transactions of a nonrecurring nature, the figures also include numerous issues in which the proceeds remained in the United States and accordingly had no effect on our balance of payments. The figures for the first half of 1963 also include, for example, a borrowing of $115 million (itself a nonrecurring transaction), $5 million of which was sold abroad and the entire proceeds of which were invested in the United States. There were several other issues during this period where the proceeds were also spent in this country.

Finally, the apparent improvement since the tax was announced may well be illusory, since uncertainty as to the final form of the law has undoubtedly deterred many foreign issuers from coming to our market who would be willing to absorb the tax once its provisions are fixed.

After weighing the above factors it is our opinion that the harm done by discriminatory control of capital movements would wholly outweigh the small net improvement in the balance-of-payments deficit that may be expected to result therefrom.

(b) *Risk of adverse effects.*—We believe that there are three basic reasons why the tax may have an adverse effect on our balance of payments and on the position of the United States as the leading international capital market:

(1) The proposed tax represents a step backward from all of our Government's postwar efforts to encourage and promote free trade and free capital movements. The recent Presidential task force on promoting increased foreign investment in U.S. corporate securities stated what has long been U.S. policy when it recommended that our Government encourage the removal of exchange controls and capital issues controls in advanced capital-forming countries. Such requests directed toward other governments are not likely to meet with wholehearted cooperation if we now set up the very kind of restriction we are urging others to eliminate. It has been said that the proposed tax is not designed to cut off foreign borrowers, but only to assure that foreign issuers do not come to our market merely to take advantage of lower interest rates. In this light, the tax would seem to be in essence a protective tariff, which is hardly consistent with the trade policies espoused by our Government for many years. The tax, whatever name it is given, actually imposes a measure of exchange control. This short-term, stopgap measure already shows signs of resulting in long-term impairment of our international capital market, and any temporary relief realized therefrom must be weighed against the reduced dollar inflow in future years.

(2) The tax strikes at the one kind of outflow which returns more than is expended—that is, investment in income-producing assets. Income from foreign portfolio investments has grown rapidly in recent years and, together with income from short-term investments, amounted in 1963 to over $900 million. The long-term effects of the tax can only be adverse to our balance of payments. Indeed,

we should be encouraging, not hindering, the investment abroad of funds which generate an immediate and liberal return all of which consititutes a capital inflow.

(3) The countries that would be most affected by the tax are among those that make significant contributions to this country's favorable balance of trade, and imposition of the tax may well result in declines not only in exports but in other areas of our international accounts as well. This point is particularly evident in the case of two countries that our firm has served, Canada and Australia. Both countries in the postwar era have had substantial deficits in their current accounts. Although they have borrowed in other countries, those markets has never been able to provide capital in adequate volume and neither country could have financed their deficits in international accounts without resorting to the U.S. securities market. The importance of this financing to the United States is indicated by the fact that Canada's trade deficit with this country in the 5 years 1959 63 totaled just under $3 billion and Australia's trade deficit with this country in the same period amounted to slightly less than $700 million.

5. Conclusion

We have set forth above the reasons why we believe the proposed tax would not be effective in solving our balance-of-payments problems and would be detrimental to the best interests of our country. We believe that there are basic factors at work leading to a long-term improvement in our balance of payments, and that under today's conditions the measure is unnecessary. If it is enacted, we believe that there is considerable risk that the proposed tax will prove self-defeating.

We believe that the key to remedying the balance-of-payments deficit of the United States lies in reductions in those Government expenditures abroad which contribute to an outflow of dollars. In our opinion this problem must be confronted and such reductions made as promptly as possible. If emergency measures are indicated, there are outflows of a nonproductive nature (such as tourist expenditures, which rose 11 percent to $2.6 billion in 1963), which we believe would be more appropriate subjects for regulation. In addition, we approve of last year's increase in the discount rate aimed at curtailing the outflow of short-term capital, and we believe that further increases should be made if necessary.

If, however, the Congress should determine that the proposed tax must be adopted, we urge the following amendments to reduce inequities and minimize the adverse effects on the U.S. capital market and foreign trade:

(*a*) We recommend that if a specified percentage, say 75 percent, or more of a foreign issue is sold outside the United States, the entire issue should be exempted from the tax. If less than the specified percentage of the issue were sold abroad sales in the United States would be taxable. The Secretary of the Treasury or his delegate would have the authority to increase or decrease the required percentage according to the balance-of-payments position prevailing from time to time.

In our opinion such a provision would preserve an important measure of the international capital market in this country, with the balance of-payments impact being readily regulated by the Treasury. Although the amounts sold here would be small, the mechanism which has proved so effective in the past would be preserved. Foreign issues could be registered with the Securities and Exchange Commission, listed on the New York Stock Exchange and marketed by both U.S. and foreign underwriters. Such a procedure would give foreign purchasers some of the elements which have been most important to them in the past, including the high standards of investigation and disclosure required by the SEC, the assurance of maximum marketability afforded by a listing in New York and the experienced and efficient services of the U.S. investment banking industry. It would enable foreign issuers to tap the resources of foreign investors through the medium of the U.S. international capital market, and would maintain that market in a state of viability and readiness to resume its former role when this country's payments difficulties have passed.

(*b*) We recommend that foreign issues be exempted from tax where the proceeds are escrowed with a bank or trust company and paid out only in payment for goods purchased in the United States, for services provided by U.S. residents or for the purchase or redemption of securities held by U.S. persons.

In this connection, we believe the following figures from our own experience are of interest. The Treasury figures for the first half of 1963 show purchases by U.S. residents of Western European securities amounting to $219 million.

During this period, Morgan Stanley & Co. managed or comanaged Western European issues totaling $172.5 million, of which $167.5 million were purchased by U.S. persons and $5 million were purchased by foreign investors. Approximately $160 million of the proceeds of these issues was spent in the United States and did not affect our balance of payments.

The House version of the tax bill provides a number of exemptions designed to prevent the tax from interfering with the fundamental policy of the U.S. Government to promote exports. These provisions include exemptions for the acquisition of foreign securities by U.S. exporters in connection with the sale of goods produced in the United States or of services rendered by the U.S. person acquiring the security, as well as where the proceeds are used for the storage, processing, or other handling of goods produced in the United States by the person acquiring the security. These provisions evidence a clear intent to free from the tax the acquisition of a foreign security in connection with the financing of U.S. exports, and require only that a substantial portion of the purchase price be attributed to such a transaction. The important national objectives that lie behind exempting such transactions when the security is acquired directly by the exporter or when the purchase is financed by the Export-Import Bank are no less pressing when the foreign purchaser finances them through the financial markets. Our proposal would insure that every dollar raised would go directly to finance exports. To the extent that such issues were sold to foreigners there would be an immediate inflow of dollars into the United States.

We also think that issues sold to refund dollar issues previously sold in the United States could be exempted without serious effect on the balance of payments. While considerable portions of such issues are held by foreigners, we believe that a roughly similar portion of a refunding issue would be bought by foreigners, with the result that there would be no material net outflow of capital. Such a provision would prevent the severe impact which the tax would otherwise have on countries which had been large borrowers in this country in prior years. To cite one example, Australia has dollar payments due in this country in the next 12 months of some $38 million, exclusive of dollar payments due to the World Bank.

In conclusion, we recommend that this committee reject the interest equalization tax at this time. If the free operation of the U.S. capital market in the second half of this year results in a greatly increased net outflow after taking into account the level of bank loans, and if this outflow is uncompensated for by basic improvements in the balance-of-payments structure, we and other firms concerned with international finance will be glad to cooperate with the Treasury in devising a mechanism that will meet the problem without unnecessarily damaging the valuable national asset represented by our international capital market.

BACHE & CO.,
New York, July 1, 1964.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Bache & Co. and the Nikko Securities Co., Ltd., desire to submit for your consideration a proposed amendment to H.R. 8000 designed to permit a U.S. investment company to be treated as a foreign issuer.

Bache & Co. and Nikko are considering participating in the establishment of a mutual fund which would invest in Japanese securities, the stock of which would be sold entirely outside the United States, primarily in Canada and Europe. It is proposed that, at least initially, there be substantial U.S. representation on the board of directors of the fund, and that its investment adviser be located in the United States.

Bache and Nikko desire to register the fund under the Investment Company Act of 1940. Under such circumstances the fund could qualify as a regulated investment company under sections 851–855 of the Internal Revenue Code of 1954, but only if the fund is a domestic corporation. As a domestic corporation the fund and its shareholders could obtain the benefits of treaty provisions which the United States has entered into with numerous foreign countries, which benefits are designed to prevent or ameliorate the burden of double taxation. Such a fund, however, could not invest in Japanese securities without bearing the burden of the interest equalization tax. As a "domestic corporation," the proposed fund would be regarded as a "U.S. person" under section 4920(a) (4) (C)

of H.R. 8000 and therefore would be subject to the imposition of the tax on acquisitions of Japanese securities.

If such a fund could elect to be treated as a foreign issuer for purposes of the interest equalization tax, the tax would be imposed only upon U.S. persons who invest in the fund. Since Bache and Nikko desire to raise the capital for the fund entirely outside of the United States, there should be no need for the imposition of the interest equalization tax from the standpoint of the balance of payments. Indeed, it is believed that such a fund may facilitate broader utilization of the European capital market.

The bill presently contains a provision permitting certain U.S. investment companies, in existence on July 18, 1963, and which hold mainly foreign securities, to elect to be treated as foreign issuers for purposes of the tax. See section 4920(a)(3)(B) of H.R. 8000. Accordingly, after the effective date of election, acquisitions of foreign securities by such an investment company are not subject to the tax. As a corollary, acquisitions of the shares of such a company by U.S. persons after the effective date of election are subject to the tax. The election permits such investment companies to make changes in their foreign investments free of tax but subjects the raising of new capital, if any, in the United States to interest equalization tax liability.

This election is not available to the proposed fund, simply because the fund was not in existence on July 18, 1963.

We believe that the proposed fund should be entitled to elect to be a foreign issuer. The imposition of tax on the acquisition by such a fund of Japanese securities does not serve the purpose of the interest equalization tax. The proposal was aimed at one aspect of the unfavorable U.S. balance of payments; namely, the outflow of long-term capital from the United States. The proposed investment company, however, would raise its funds exclusively in foreign capital markets. Its operation would not employ the American capital markets at all.

The proposed fund, and others like it, should have a salutory effect on the U.S. balance of payments. According to the Treasury testimony before your committee on Monday, June 29, 1964, Japanese securities can be expected to find U.S. purchasers despite the interest equalization tax since, even with the tax, the Japanese may raise capital in the United States more cheaply than at home. The proposed fund and others like it, if successful, may reduce the pressure on the U.S. capital market to supply the capital needs of Japanese industry.

As President Kennedy pointed out in his special message to Congress dated July 18, 1963, the proposed tax is designed to encourage improvements "in both our balance of payments and in the operation of foreign capital markets * * *".[1] The issuance and trading in European markets of mutual fund shares may lead to a more flexible and diversified utilization of European savings. In particular, it might widen the range of individuals and institutions willing to make relatively small diversified investments, thus rectifying one of the major defects noted in the Treasury Department's analysis of European capital markets.[2]

For the reasons stated above, it is suggested that the section of H.R. 8000 stating the sorts of investment companies which may have the election to be treated as a foreign issuer or obligor, section 4920(a)(3)(B), be amended to read as follows:

"* * * a domestic corporation which [, as of July 18, 1963, was] *is* a management company registered under the Investment Company Act of 1940 if—

"'(i) at least 80 percent of the value of the stock and debt obligations owned by such corporation on July 18, 1963 (*or, in the case of a corporation created after July 18, 1963, at the end of its first taxable year other than a taxable year of less than twelve months*), and at least 80 percent of the value of the stock and debt obligations owned by such corporation at the end of every calendar quarter thereafter (through the quarter preceding the quarter in which the acquisition involved is made), consists of stock or debt obligations of foreign issuers or obligors and other debt obligations having an original maturity of 90 days or less;

"'(ii) such corporation elects to be treated as a foreign issuer or obligor for purposes of this chapter; and

---

[1] Special message from the President on "The Balance of Payments," H. Doc. 141, 88th Cong., 1st sess., p. 8 (1963); see also Joint Economic Committee, "The United States Balance of Payments," S. Rept. 965, 88th Cong., 2d sess., pp. 8–9 (1964).

[2] Joint Economic Committee, 88th Cong., 2d sess., paper No. 3, "A Description and Analysis of Certain European Capital Markets," p. xi (committee print, 1963).

"'(iii) such corporation does not materially increase its assets during the period from July 18, 1963, to the date of such election through borrowing or through issuance or sale of its stock (other than stock issued or sold on or before September 16, 1963, as part of a public offering with respect to which a registration statement was first filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days before that date).'

The election under clause (ii) shall be made on or before the 60th day after the date of the enactment of this chapter, *except that in the case of a corporation created after such date of enactment, such election shall be made on or before the date on which it first issues stock (other than directors' qualifying shares)* under regulations prescribed by the Secretary or his delegates * * *."

Very truly yours,

BACHE & Co.
BRODERICK HASKELL.
THE NIKKO SECURITIES Co., LTD.
TOSHIO G. OZEKI.

STATEMENT OF DAVIS POLK WARDWELL SUNDERLAND & KIENDL, NEW YORK, N.Y., SUBMITTED BY DAVID A. LINDSAY

Mr. Chairman, we should like to submit for your consideration a suggested change in section 4912(b)(1) of H.R. 8000. The proposed change would exempt from the interest equalization tax contributions by a U.S. employer to a qualified foreign pension or profit-sharing trust which has been created and maintained for the benefit of employees in a foreign country.

1. Treatment of contributions to foreign pension or profit-sharing trust under H.R. 8000 as passed by the House of Representatives

Under the bill as it passed the House, contributions by a U.S. employer to a qualified foreign pension or profit-sharing trust for the benefit of its employees in a foreign country may be subject to liability for the interest equalization tax. Each contribution is deemed an acquisition by the U.S. employer of foreign stock in an amount equal to the actual value of the money or property transferred, to the extent that such trust acquires stock or debt obligations which would, if acquired directly by the U.S. employer, be subject to the interest equalization tax.

Under the bill, any transfer to a foreign trust is not deemed a taxable acquisition if it constitutes "a sale or exchange for full and adequate consideration." Ordinarily, it would appear that contributions to a foreign pension or profit-sharing trust would constitute a transfer for full and adequate consideration, such consideration being the services performed by oversea employees. However, such a contribution is apparently subject to tax under the bill as drafted, since it would not constitute a "sale or exchange."

Section 4912(b)(1) of the bill does exempt contributions made by certain employees to a foreign pension or profit-sharing trust but no similar exemption exists for the employer's contributions. Thus section 4912(b)(1) provides in part that contributions to a foreign pension or profit-sharing trust established by an employer, made by an employee who performs personal services for such employer on a full-time basis in a foreign country, shall not be considered as transfers which may be deemed acquisitions of stock of a foreign issuer.

2. Proposed amendment

We believe section 4912(b)(1) should be amended so as to provide that contributions to a foreign pension or profit-sharing trust established by an employer for the exclusive benefit of employees who perform personal services for such employer on a full-time basis in a foreign country shall not be considered as transfers which may be deemed acquisitions of stock of a foreign issuer.

We accordingly propose that section 4912(b)(1) of H.R. 8000 be amended to read as follows:

[New matter in italics]

(1) CERTAIN TRANSFERS TO FOREIGN TRUSTS.—Any transfer (other than in a sale or exchange for full and adequate consideration) of money or other property to a foreign trust shall, if such trust acquires stock or debt obligations (of one or more foreign issuers or obligors) the direct acquisition of which by the transferor would be subject to the tax imposed by section 4911, be deemed an acquisi-

tion by the transferor (as of the time of such transfer) of stock of a foreign issuer in an amount equal to the actual value of the money or property transferred or, if less, the actual value of the stock or debt obligations so acquired by such trust. *Contributions to a foreign pension or profit-sharing trust established by an employer made by such employer for the exclusive benefit of employees who perform personal services for such employer on a full-time basis in a foreign country, and* [c]ontributions to a foreign pension or profit-sharing trust established by an employer, made by an employee who performs personal services for such employer on a full-time basis in a foreign country (and is not an owner-employee as defined in section 401(c)(3)), shall not be considered under the preceding sentence as transfers which may be deemed acquisitions of stock of a foreign issuer.

3. Reasons for proposed amendment

The basic rule in H.R. 8000 that imposes a tax on indirect acquisitions of foreign securities, through transfers to foreign trusts, may be sound to prevent avoidance but makes no sense whatsoever when applied to foreign currency contributions to a foreign pension or profit-sharing trust for the benefit of employees in a foreign country.

Pension payments are simply a form of compensation payment, and the interest equalization tax is not intended to be applied to compensation generally. Foreigners and others employed by a U.S. corporation in a foreign country whose terms of employment provide for compensation payable in foreign currency usually will continue to reside in the country of employment after retirement and should be entitled to pensions payable in the currency of such country from a fund of securities also payable in such currency.

Two cases have come to our attention in which contributions by U.S. employers to foreign pension or profit-sharing trusts would apparently become subject to the interest equalization tax, although in neither case does it seem that such treatment is warranted or intended by the purpose of the tax as expressed in the report of the Committee on Ways and Means. Morgan Guaranty Trust Co. of New York, for example, has had for over 10 years a trusteed pension plan for the benefit of employees of its branches in the United Kingdom, which is funded through the medium of a United Kingdom trust into which monthly sterling contributions are made by the London branches as current operating expense. The major purpose for creating this foreign pension trust for the oversea branches was to provide pension benefits in pounds sterling (the currency in which salaries are paid) from earnings generated in the United Kingdom. If the pension plan were to be funded in dollars rather than sterling securities and the plan were to call for dollar benefits rather than sterling benefits, the pensioners would be subject to risks of currency fluctations. It is generally believed that risks of fluctuation of currency exchange, whether borne by the trust or the beneficiary, are entirely inappropriate in the context of pension commitments.

In the second case, Chubb & Son, Inc., a firm engaged in the business of managing insurance companies, has contemplated creating a Canadian pension trust for its employees in Canada. Canada has had under consideration proposals to make such a pension trust mandatory in certain cases. Moreover, Chubb & Son, Inc., has been advised by Canadian counsel that the Canadian employees may be currently exempt from tax on the employer's contributions only if such contributions are made to or under a "registered pension fund or plan" in Canada. Ordinarily, a registered pension fund or plan requires a Canadian trust, but such a trust in Canada is exempt from Canadian income tax only if not less than 90 percent of its income is from Canadian sources. Here again, Chubb & Son, Inc., contemplates making contributions to the Canadian trust in Canadian currency from earnings generated in Canada.

The practical utility of creating a foreign pension or profit-sharing trust for oversea employees of a foreign branch has been recognized by the Congress. Thus section 404(a)(4) of the Internal Revenue Code of 1954 provides that if a stock bonus, pension, or profit-sharing trust would qualify for exemption under section 501(a) except for the fact that it is a trust created or organized outside the United States, contributions to such a trust by an employer which is a resident, or corporation, or other entity of the United States, shall be deductible in the same manner as contributions to qualified domestic stock bonus, pension or profit-sharing trusts.

If section 4912(b)(1) is allowed to remain in the form as passed by the House of Representatives, the effect appears to be that foreign branch contributions in foreign currency toward the cost of pension benefits payable in foreign currency which are provided through the medium of a foreign trust would be subject to the interest equalization tax, whereas similar foreign currency benefits paid direct to a retired employee by a current charge against foreign branch income would not be subject to this tax.

It is submitted that provision for foreign currency pension benefits under the circumstances described above is a normal business expense incident to the production of income abroad which has a beneficial effect on U.S. balance of payments, and that provision for such benefits should not be subject to the interest equalization tax, regardless of the medium of financing. Indeed, we cannot believe that it was the intention of the House to produce the inequitable and incongruous result which the present section 4912(b)(1) appears to require, and the language of the section should be amended to make clear that such result was not intended.

4. Conclusion

The Congress, through the Revenue Code, has encouraged employers in the funding of pension benefits within well-prescribed limits as being in the public interest. Similarly, many foreign governments have prescribed terms and conditions for pension arrangements which the U.S. employer operating and generating earnings abroad must satisfy in order to obtain reasonable tax treatment under their laws. The Congress, by section 404(a)(4) of the Revenue Code of 1954, appears to have recognized that foreign trusts are a normal means for a U.S. employer to provide pensions for foreign employees. It is logical to believe that section 4912(b)(1) of H.R. 8000 as now phrased would have the unfortunate effect of discouraging further funding of foreign pensions through foreign trusts. Instead, such pensions would be charged to current expense of the foreign branch on a pay-as-you-go basis (with no helpful effect on the balance-of-payments position) or provided in dollars from domestic trusts.

Accordingly, it is respectfully submitted that section 4912(b)(1) should be amended so as to clearly provide that contributions by an employer to a foreign pension or profit-sharing trust established by an employer for the exclusive benefit of employees who perform personal services for such employer on a full-time basis in a foreign country shall not be considered as transfers which may be deemed acquisitions of stock of a foreign issuer.

SEATTLE, WASH., *July 3, 1964.*

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: At the suggestion of Senator Henry Jackson, enclosed find series of amendments which I propose for H.R. 8000. I have appended an explanation of each proposed amendment, which I believe adequately states my argument.

Of course, in principle, I am opposed to the act, but feel these amendments would make it a better bill than it now is.

I am also sending a copy of the proposed amendments and explanation to Senators Jackson and Magnuson. I sincerely hope a successful effort can be made in this regard.

Yours very truly,

RALPH E. PURVIS.

PROPOSED AMENDMENTS H.R. 8000

1. Amend section 4914, subsection (b), page 14, line 24. After the end of subsection (7) add a new subsection to be numbered (8) as follows:

"(8) ACQUISITIONS BY USE OF FUNDS ON DEPOSIT IN FOREIGN COUNTRY PRIOR TO EFFECTIVE DATE.—Of stock obligations by United States persons to the extent that the purchase price is derived from funds on deposit in the foreign country or invested in foreign stock obligations prior to the effective date of this Act."

Explanation

Suppose a U.S. person owned 1,000 shares of McMillan, Bloedel & Powell River, Ltd., prior to the effective date of the act. This is a Canadian timber and pulp company. After the effective date of the act, this person decides to switch the money invested in these shares by selling the same and with the

proceeds he buys shares in Noranda Mines, Ltd., a Canadian mining company. Under the bill as it is now written, this purchase of Noranda would be subject to the 15-percent tax.

The taxation of transactions such as the above, arising out of switching of investments, is obviously most unfair. Also the same unfair result is reached with regard to funds on deposit in a foreign country prior to the effective date, when those funds are used to make a purchase of foreign stock at a time subsequent to the effective date.

Treasury apparently has objected to a blanket exclusion because it would permit the purchase of short-term foreign debt obligations, taxable at the minimum rate, and the subsequent switching of this investment into long-term bonds, otherwise taxable at maximum rates, without any further tax liability. The proposed amendment is limited to stock obligations and does not include debt obligations. Therefore this objection by the Treasury has been met and Treasury should now approve this amendment, the scope of which is now limited to satisfy the previous objection of Treasury.

The purpose of the act is to prevent further outflow of U.S. funds. The dollars already located outside the United States prior to the effective date of the act should be exempted from the operation of the act, and this amendment accomplishes that result with regard to stock purchases as distinct from debt obligations, by the use of such funds.

2. Amend section 4915 subsection (a), subparagraph (1), page 32, line 11. After the words "or indirectly)" and before the words "percent" delete the figure "10" and insert in lieu thereof the figure "5".

In line 15, after the words "or indirectly)" and before the words "percent" delete the figure "10" and insert in lieu thereof the figure "5".

Explanation

This section makes exempt stock purchases which result in ownership of 10 percent or more of the shares of a foreign company. The reason for the amendment is to make it possible for the small businessman in the United States or the smaller investor, to acquire substantial interests in foreign companies without being subject to the tax.

3. Amend section 4915 subsection (a) subparagraph (2), page 33, line 6. After the words "acquisition was made" and before the words "and as" insert the following: "or to the last day of the calendar year of 1964,".

Explanation

Suppose a person owned only 8 percent of the outstanding issued stock of foreign company X prior to the effective date, which is July 18, 1963. This person is uncertain during 1963 as to whether the act will pass Congress and therefore he did not purchase any additional shares of company X during 1963. However, in 1964, this person decides after the passage of the act that he should increase his ownership in company X to more than 10 percent of the issued shares. So he purchases enough additional shares so that he is the owner of more than 10 percent in 1964. Under the act as it is now written, this purchase in 1964 would be taxable even though it accomplished the same result which would have been tax free if the purchase had been made in 1963. Of course this situation was not foreseen when the House passed the act in March of 1964. The need for this amendment should now be quite obvious.

New York, N.Y., *July 6, 1964*.

Re H.R. 8000.

Hon. Harry F. Byrd,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

My Dear Mr. Chairman: There is submitted herewith, for the consideration of the Committee on Finance, a proposed amendment to H.R. 8000—the Interest Equalization Tax Act—and a memorandum in explanation and support of the proposed amendment.

This amendment is submitted in the conviction—based on a study of the economic policy involved and its impact on specific corporations operating in less-developed countries and in the United States—that the bill as drafted fails to carry out the announced purposes of the legislation in a reasonable and equitable manner.

Your consideration of the proposed amendment, and its consideration by the committee, will be appreciated.

Sincerely yours,

ROBERT M. KAUFMAN.

MEMORANDUM IN SUPPORT OF PROPOSED AMENDMENTS TO H.R. 8000, INTEREST EQUALIZATION TAX ACT

H.R. 8000 (the Interest Equalization Tax Act) is intended to deal with a major aspect of the U.S. deficit in the balance of payments, resulting from the flow of long-term investments to foreign countries. At the same time, it is intended to provide relief for investments in less-developed nations, where the United States has a special interest in fostering investment and economic development. This intent is basic to the bill as passed by the House of Representatives and as proposed to be amended pursuant to the recommendations of the Secretary of the Treasury dated June 12, 1964.

Throughout the history of this legislation, from President Kennedy's special message on balance of payments of July 8, 1963, through the testimony of the various witnesses who appeared before the two committees, it has been pointed out that the tax is directed principally at the balance-of-payment problem as it is affected by long-term capital outflow.

The report of the House Committee on Ways and Means on H.R. 8000 (H. Rept. 1046, 88th Cong., 1st sess.) noted as follows:

"The tax is designed to aid our balance-of-payments position by restraining the heavy and accelerated demand on our capital market from *other* industrialized countries." [Emphasis supplied.]

The quoted language of the House committee points out the basic problem at which the pending legislation is directed—the flow of U.S. capital to other industrialized nations—conversely, it is clear that the act would not adversely affect the flow of capital into the United States, irrespective of whether such capital originated in the United States or abroad, or encourage the withdrawal of capital from the United States.

There is submitted herewith a proposed amendment to H.R. 8000, drafted in terms of the amendments to the act proposed by the Treasury (also attached is a parallel amendment drafted in terms of the act as it passed the House) which, it is submitted, will further the basic purposes of the act. It will eliminate certain potential inequities which have no useful purpose in the balance-of-payment situation, and will give adequate recognition to the importance of encouraging foreign corporations to make investments in this country and of discouraging withdrawal of foreign investment in the United States.

H.R. 8000, as passed by the House, apparently failed adequately to recognize that investments in the United States, as well as deposits in U.S. banks, are a most desirable use of foreign investments in terms of U.S. policy. For, when a U.S. resident purchases securities of a foreign company which represent or become an investment in the United States or a deposit in a U.S. bank, such a purchase of foreign securities does not represent a net outflow of U.S. funds. In terms of the balance of payments, the purchase has the same effect as a purchase by a U.S. resident of securities of a U.S. company or a direct deposit by a U.S. resident in a U.S. bank. Certain of the proposed Treasury amendments recognized this fact, as for example, the proposed amendments adding section 4916(c)(2)(A) which excludes from consideration income from many types of U.S. property, and section 4916(c)(1)(B)(iii) which includes certain U.S. assets in the test under section 4916(c)(1)(B). In connection with these proposed amendments, the Treasury Department memorandum states, at page 26:

"The proposed changes in this subsection are designed to prevent disqualification of less-developed country corporations from the exclusion from tax intended under this section because of investments in U.S. property or income derived from U.S. sources * * *."

However, the policy set out in the Treasury statement—of preventing disqualification of less-developed country corporations from the exclusion from tax because of U.S. investments or income derived therefrom—is not sufficiently achieved by the act as proposed to be amended by the Treasury. Thus, under the test of section 4916(c)(1)(A) (the test applicable to corporations engaged in the active conduct of trade or business), deposits in U.S. banks are qualified

assets (like assets in less-developed countries) while certain other U.S. assets (such as tangible property in the United States, stock of U.S. corporations, and obligations of U.S. persons as set forth in section 956(b)(1)) are not qualified assets. Apparently, income from deposits in U.S. banks does not qualify under section 4916(c)(1)(A) (the doing business test described above), although such income is specifically treated as qualified income under the alternate test which excludes business property from the assets test (section 4916(c)(1)(B)). Furthermore, the income from the U.S. assets described in section 956(b)(1) is not taken into account either as qualified or unqualified income.

The proposed amendments submitted herewith seek to eliminate these inconsistencies in the treatment of assets and income—inconsistencies even with the Treasury's own statement of economic policy discussed above—by applying the same treatment to all U.S. assets and the income derived therefrom. This is accomplished by providing, for purposes of the act, that the United States "shall be treated as a less-developed country." Obviously, the United States is not a less-developed country—but the public policy sought to be achieved by the act is best accomplished by making this clear distinction between the United States and less-developed countries on the one hand, and the foreign industrialized nations on the other. The economic policy interests of the United States with respect to investments in this country are at least equal to its foreign policy interests with respect to investments in less-developed countries. This technique is not new, and a similar approach is contained in the Treasury regulations under the Internal Revenue Code (reg. sec. 1.955-6(b)(2)), which provide that gross income derived by foreign corporations from interest on obligations of the United States "shall be treated as income from sources within less-developed countries."

The proposed provision would encourage corporations, which might otherwise be ineligible for treatment as less-developed country corporations on the basis of assets in and income from the United States, to make investments in this country. Similarly, it would avoid the possibility that the act would force foreign corporations with the bulk of their investments in less-developed countries but with some U.S. assets and income to dispose of their U.S. interests in favor of investments in other countries.

The proposed amendments also seek to eliminate a provision added by the House of Representatives, which appears to be particularly prejudicial to U.S. investors—even investors in less-developed country corporations—without any concomitant benefits to the balance-of-payments situation. The House added a clause providing that the determination of eligibility as a less-developed country corporation is to be based, in effect, on whether the corporation meets the necessary criteria during the previous annual accounting period, the current annual period and the subsequent annual period. The Treasury had originally recommended that the criterion of eligibility be based upon the current accounting period.

The result of the House provision is that a corporation (and the purchaser of securities in that corporation) is unable to determine whether or not it qualifies as a less-developed country corporation until the end of the annual accounting period subsequent to the end of the current annual accounting period—a time which may be almost 2 years from the time of the purchase. This requirement is likely to discourage investment by any U.S. resident in any foreign corporation—including foreign corporations whose assets and income at the time of the purchase clearly meet the percentage criteria for eligibility—since the investor is unable to determine definitely what the situation will be 2 years hence. It is proposed that this provision be modified so as to enable an otherwise eligible foreign corporation, and an investor in such a foreign corporation, to determine the corporation's status under the act at the time the corporation makes a new investment or the investor makes a securities purchase. Accordingly, an amendment is proposed to provide that the determination of eligibility shall be based upon the annual accounting period immediately preceding the annual accounting period in which the acquisition is made or the security is purchased. In order to cover the situation where the prior annual accounting period is less than a 12-month period, the proposed amendment grants power to the Secretary of the Treasury to specify a different period in such cases by regulations.

RE PROPOSED AMENDMENTS TO AMENDMENTS RECOMMENDED BY THE TREASURY DEPARTMENT TO H.R. 8000

SEC. 4916. EXCLUSION FOR INVESTMENTS IN LESS DEVELOPED COUNTRIES.

* * * * * * *

(c) LESS DEVELOPED COUNTRY CORPORATION DEFINED.—

(1) IN GENERAL.—For purposes of this section, the term "less developed country corporation" means a foreign corporation which for the applicable periods set forth in paragraph (3)—

(A) meets the requirements of section 955(c)(1) or (2); or

(B) derives 80 percent or more of its gross income, if any, from sources within less developed countries ~~or from deposits in the United States with persons carrying on the banking business, or both~~ and has assets 80 percent or more in value of which consists of—

(i) property described in clauses (ii), (iii), (iv), and (v) of section 955(c)(1)(B),

(ii) property described in section 956(b)(1) (regardless of when acquired), *and*

(iii) debt obligations described in paragraph (3) of subsection (a) of this section~~, and~~*;*

~~(iv) obligations of the United States;~~

except that in applying this paragraph the determination of whether a foreign country is a less developed country shall be made in accordance with subsection (b) of this section.

(2) SPECIAL RULES.—

(*A*) For purposes of subparagraphs (A) and (B) of paragraph (1)—

~~(A) income derived from property described in section 956(b)(1) (regardless of when acquired) shall not be taken into account, and~~

(*i*) *the United States shall be treated as a less developed country, and*

~~(B)~~ (*ii*) obligations of any other less developed country corporation shall be taken into account under section 955(c)(1)(B)(iii) without regard to the period remaining to maturity at the time of their acquisition~~.~~*, and*

(*iii*) *income from deposits with persons carrying on the banking business in the United States shall be considered to be income derived from sources within less developed countries and income from deposits other than in a less developed country shall not be taken into account.*

(*B*) For purposes of subparagraph (B) of paragraph (1), deposits ~~outside the United States~~ (other than deposits in a less developed country) with persons carrying on the banking business~~, and income from such deposits,~~ shall not be taken into account.

(3) APPLICABLE PERIODS.—The determinations required by subparagraphs (A) and (B) of paragraph (1) shall be made ~~(A)~~ for the annual accounting period (if any) of the foreign corporation immediately preceding its accounting period in which the acquisition involved is made, ~~(B) for the annual accounting period of the foreign corporation in which such acquisition is made, and (C) for the next succeeding annual accounting period of the foreign corporation.~~ *except that if said annual accounting period is less than a 12-month period, the determination shall be made for such period of time as the Secretary or his delegate may by regulations prescribe.*

RE PROPOSED AMENDMENTS TO H.R. 8000

SEC. 4916. EXCLUSION FOR INVESTMENTS IN LESS DEVELOPED COUNTRIES.

* * * * * * *

(c) LESS DEVELOPED COUNTRY CORPORATION DEFINED.—

(1) IN GENERAL.—For purposes of this section, the term "less developed country corporation" means a foreign corporation which for the applicable periods set forth in paragraph ~~(2)~~ (*3*)—

(A) meets the requirements of section 955(c)(1) or (2); or

(B) has gross income 80 percent or more of which is derived from sources within less developed countries, and has assets 80 percent or more in value of which consists of—

(i) property described in clauses (*ii*), (iii), (iv), and (v) of section 955(c)(1)(B)~~.~~,

(ii) property described in section 956(b)(1) (regardless of when acquired), and

(iii) debt obligations described in paragraph (3) of subsection (a) of this section;

except that in applying this paragraph the determination of whether a foreign country is a less developed country shall be made in accordance with subsection (b) of this section.

(2) SPECIAL RULES.—

(A) For purposes of subparagraphs (A) and (B) of paragraph (1)—(i) the United States shall be treated as a less developed country, and (ii) obligations of any other less developed country corporation shall be taken into account under section 955(c)(1)(B)(iii) without regard to the period remaining to maturity at the time of their acquisition, and (iii) income from deposits with persons carrying on the banking business in the United States shall be considered to be income derived from sources within less developed countries and income from deposits other than in a less developed country shall not be taken into account.

(B) For purposes of subparagraph (B) of paragraph (1), deposits (other than deposits in a less developed country) with persons carrying on the banking business shall not be taken into account.

~~(2)~~ *(3)* APPLICABLE PERIODS.—The determinations required by subparagraphs (A) and (B) of paragraph (1) shall be made ~~(A)~~ for the annual accounting period (if any) of the foreign corporation immediately preceding its accounting period in which the acquisition involved is made, ~~(B) for the annual accounting period of the foreign corporation in which such acquisition is made, and (C) for the next succeeding annual accounting period of the foreign corporation.~~ *except that if said annual accounting period is less than a 12-month period, the determination shall be made for such period of time as the Secretary or his delegate may by regulations prescribe.*

UNITED STATES COUNCIL OF THE
INTERNATIONAL CHAMBER OF COMMERCE, INC.,
New York, N.Y., July 7, 1964.

Re H.R. 8000, interest equalization tax.

Senator HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The Tax Committee of the United States Council of the International Chamber of Commerce regrets that circumstances of the hearing on H.R. 8000 before your committee made it impracticable for our members to study in depth the relationship of H.R. 8000 to the current problem of the U.S. international balance-of-payments situation, presented to the committee on June 29 by the Secretary of the Treasury. In particular, we were unable to study fully the 40-odd amendments proposed on that day by the Treasury Department, since the report on them was not available until the opening day of the hearings.

However, based on a preliminary review of the statement to your committee by the Secretary of the Treasury, we recommend that the Senate Committee on Finance should not report this bill favorably, even with acceptance of all the amendments proposed by the Treasury Department on June 29. The members of the United States Council recognize the vital nature of the need to reverse the outflow of gold from the United States and were pleased at the Secretary's report of considerable progress on the Treasury's long-range plan to improve the balance-of-payments situation, and his expression of confidence that substantial success will be achieved in the very near future. However, we question whether the proposed legislation would contribute substantially to the solution of this problem. We urge that the members of your committee keep constantly in mind the possible impact of this legislation on international trade and investment and the attendant effects on U.S. relations with other nations. Creation of restrictions on the movement of U.S. capital of the sort included in H.R. 8000 at a time

when our Government is urging others to open their capital markets to foreigners does not seem to be sound policy.

In addition, it seems generally understood that, although while the bill is pending new financing in the U.S. market by foreign enterprises outside Canada has been largely stopped, this financing will resume when the final decision is known whether or not the provisions of the bill are adopted by the Congress. That is, Japan and Europe will reenter our markets when the bill is passed or when the Congress adjourns without passage. The Secretary of the Treasury expressed confidence that passage of the bill in its present form with its retroactive date would be constitutional, but it appears unlikely that the 89th Congress would pass such a bill with a 1963 retroactive date.

Furthermore, the exemption in the bill before you, including that for Canada and the possibility that other countries might be included, present the dilemma that either the bill will have so little effect as to not produce the hoped-for restriction on the outflow of funds, or to the extent it is effective it will create the many disturbances to our international trade and economic position which opponents of the bill have presented to you.

The members of the United States Council recognizes the many pressures on the Congress and on your committee for prompt action on this important piece of legislation. Therefore, the following comments are directed to the bill now before your committee, and include comments on the amendments recommended by the Treasury Department by letter to you dated June 12, 1964.

1. The bill and the Treasury proposals provide for exemption of certain specified acquisitions of debt and equity securities incident to normal business transactions. However, these exemptions do not recognize the broad scope and variety of financial transactions involved in doing business abroad, and in fact we do not believe it possible to cover such transactions by specific provisions. American businesses operating in foreign countries must be prepared to make investments of many kinds in order to improve their position, such as, for example, loans to employees, purchases of securities of nonprofit organizations, investments in foreign banks to facilitate financing of their own operations and those of their customers and suppliers and the like. We believe there should be a blanket exemption for purchases of securities otherwise covered by the bill if, under regulations to be proposed by the Secretary or his delegate, the "U.S. person" investor can demonstrate that the securities acquired were purchased for business purposes and not as portfolio investments. We do not believe such a broad provision would be difficult to administer.

2. The bill would impose the interest equalization tax on purchases of foreign securities by nonresident citizens of the United States. It is normal, and indeed it is expected of such citizens, that they will purchase securities of foreign corporations operating in the countries of their residence including securities of their foreign employers. To the extent that such purchases are made from funds earned abroad in foreign currencies, the U.S. balance-of-payments position is not affected, and thus imposition of tax on such transactions is not only a needless hardship on these citizens but is not within the purpose of the proposed bill.

3. If the committee does not adopt the suggestion in the preceding paragraph, it is recommended that exemption be provided for purchase of securities of foreign corporations by their U.S. nonresident citizen employees when the purchase has a relationship to employment, such as stock purchase plans or options or the like. It seems quite unreasonable to impose a penalty tax on some of the employees of a foreign corporation merely because they are U.S. citizens, and again the U.S. balance-of-payments problem is not at issue.

4. We recommend that the bill provide a complete exemption for purchases of existing foreign securities, that is, foreign securities which were outstanding on the effective date of the act. The statistics presented to your committee indicate that transactions in such securities in the American markets are not a significant factor in the balance-of-payments problem, and in fact in some periods the net effect is an inflow of gold. It seems clear that the purchase and sale of foreign securities by Americans is influenced by many economic factors including rates of return here and abroad, and economic prospects in this and in foreign countries. Imposition of the interest equalization tax will have no effect on the balance of these transactions other than to impose a needless penalty on the American investor.

5. If the suggestion in the preceding paragraph is not adopted, we recommend that when the President determines that application of the tax would threaten

international monetary stability the exemption should cover existing securities as well as new issues. Adoption of this proposal would recognize that one of the justifications for taxing outstanding issues in the first place is to make the tax on new issues effective. However, as already indicated, we do not think this justification is sound.

6. An attempt has been made in H.R. 8000 to limit the proposed tax to portfolio investments. The exemption for direct investments is restricted, however, to persons owning at least 10 percent of the stock of the foreign corporation whose stock or obligations are acquired. The 10-percent figure is too high to provide an adequate basis for distinction between portfolio investments and direct investments. Investments should be exempt when made by less than 10-percent stockholders if they are investments in foreign corporations engaged in operations similar or related to those of the investor.

7. We are quite concerned about the administrative problems and potential penalties on American investors and others of the July 19, 1963, effective date for transactions. The bill necessarily includes complicated provisions for reporting transactions in foreign securities since that date, and both civil and criminal penalties may be incurred by investors and their agents for possibly inadvertent failure to comply with the provisions of the act. Furthermore, while security dealers and others have been on notice as to the possible enactment of the bill, and have taken elaborate steps in preparation for compliance, inadvertent noncompliance may still occur. It is recognized that an effective date of enactment of the act might give an opportunity for avoidance of the provision of the bill for a short period. This would not occur if the date of enactment were changed to the date the Finance Committee reports on the bill, and we so recommend.

Sincerely,

PHILIP YOUNG, *President.*

BROTHERHOOD OF RAILROAD TRAINMEN,
BOARD OF TRUSTEES,
Cleveland, Ohio, July 7, 1964.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR BYRD: On August 23, 1963, I appeared before the House Committee on Ways and Means and gave the following quoted statement with reference to H.R. 8000:

"My name is J. H. Smith, member of the board of trustees of the Brotherhood of Railroad Trainmen, with headquarters in Cleveland, Ohio.

"The brotherhood is a fraternal organization international in scope, in that 10.64 percent of its membership is comprised of Canadian citizens residing in that country.

"While the headquarters of this organziation is based in the United States, dues and insurance premiums paid by our Canadian members are deposited directly by our local treasurers in Canadian banks. Consequently, the Canadian members' money does not, therefore, come across the border. We do not appear today in opposition to H.R. 8000 in toto, as we are cognizant of the administration's responsibility in restoring both confidence in the dollar and the eventual equilibrium in our international accounts.

"We would request your committee, however, to give consideration to a circumstance such as in the case herein described. Specifically, we would request that the present bill be amended to permit fraternal organizations to reinvest funds which are already in Canada in Canadian securities without being subjected to the tax that would be imposed by the proposed legislation."

The bill as reported out of the House committee and passed by the House contains language prayed for by the organization I represented in my testimony on August 23, 1963.

The purpose of this letter is to request that the Senate committee likewise give favorable consideration to the problem as outlined in the above quoted.

Respectfully yours,

J. H. SMITH.

THE INTERNATIONAL NICKEL CO., OF CANADA, LTD.,
OFFICE OF THE VICE PRESIDENT,
New York, N.Y., July 7, 1964.

Re section 4920(a)(3) of the interest equalization tax bill (H.R. 8000).

Senator HARRY FLOOD BYRD,
Chairman, Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing, as vice president of the International Nickel Co. of Canada, Ltd., to explain our support of the provision in section 4920 (a)(3) of the interest equalization tax bill (H.R. 8000) as approved by the House of Representatives, which provides an exclusion from the proposed tax for foreign corporations that are traded on a U.S. national securities exchange registered with the Securities and Exchange Commission, if trading on U.S. exchanges provides the principal market for the stock and if more than 50 percent of the stockholders on the last record date before July 19, 1963, were U.S. persons. The language I refer to appears on lines 1 through 11 on page 57 of the bill before your committee.

This provision was added to the original draft of the bill with the active consent of the Treasury Department. As Secretary Dillon stated in his testimony before the Finance Committee on June 29, 1964, while discussing this provision, "Close association of these companies with the United States justifies their treatment as domestic companies."

The International Nickel Co. of Canada, Ltd., is incorporated under the laws of Canada, but has always been closely associated with the United States. The company carries on very substantial operations in the United States and is a major source of this country's nickel. The company's stock and that of its predecessors have been listed on the New York Stock Exchange since 1915, and the New York Stock Exchange has always been the principal market for its shares.

Approximately 31,000 of International Nickel's shareholders are shown by our records to be U.S. citizens or residents, and as of May 21, 1963, the company's last record date before July 19, 1963, 57.2 percent of its stock was owned of record by U.S. citizens or residents. Indeed, transactions in International Nickel stock are so much a part of the domestic financial structure that International Nickel is one of the 30 companies used as a basis for the Dow Jones Industrial Average, and its shares are also included in the New York Times and the Standards & Poor's index.

Dividends paid by the company to stockholders in this country have substantially assisted the U.S. balance-of-payments position through the years. Since 1931, the date of the last public issue of its stock, International Nickel has paid over a half billion dollars in dividends to U.S. citizens or residents.

Only seven other companies listed on the New York Stock Exchange would be exempted under this provision. The largest of these is Aluminum, Ltd., which is 73 percent owned by U.S. persons. The other six companies that would be excluded are listed in the testimony of our chairman, Mr. Henry S. Wingate, before the House Ways and Means Committee, which may be found beginning on page 269 of the printed copy.

Exclusion of stock issued by these firms from the interest equalization tax would not adversely affect the U.S. balance-of-payments position and there are positive reasons why the exemption should be made:

1. It would permit continuation of the common world market which has always existed for trading in the shares of International Nickel and other widely traded foreign companies which are majority-owned by U.S. persons.
2. This exclusion will result in equal treatment for shareholders of foreign companies in which Americans own at least 50 percent of the stock and shareholders of U.S. companies in which foreigners own a substantial number of shares.

I am submitting this letter for inclusion as part of the committee's record in connection with the proposed bill.

Sincerely yours,

RICHARD A. CABELL.

FIRST NATIONAL CITY BANK,
New York, N.Y., July 7, 1964.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The views of my bank on the interest equalization tax are set out at length in the article entitled "Interest Equalization Tax: A Deceptive Tourniquet," which appeared in the enclosed issue of our Monthly Economic Letter in April 1964.

I am writing now to urge you strongly that, if you do report the interest equalization tax bill out of your committee, you add language to it that would make it clear that loans made by foreign branches of American commercial banks in foreign currencies are not subject to the tax regardless of type or duration.

The intent of the bill is to check the outflow of dollar capital from the United States. Section 4914(b)(2) properly exempts loans of a commercial bank made in the ordinary course of its commercial banking business so as not to interfere with the financing of our vital export trade.

The language of this section does not fully take into account commercial banks, like my own, that have worldwide branch networks in foreign countries. Our bank has 100 branches and affiliates in 37 countries outside of the United States. The business of those branches is essentially to accept deposits in foreign currencies and to use those deposits to make loans. The earnings from this foreign currency business are then converted into dollars and remitted to the United States. Loans made by our foreign branches in foreign currencies thus involve no dollar outflow and, in fact, from the balance-of-payments point of view, earnings on them are net current receipts when remitted to the United States. Additionally, to the extent that these foreign currency loans are made available to foreign subsidiaries of American firms, the U.S. head office does not have to export U.S. dollars to cover their subsidiaries' financial needs. In the national interest, they should be encouraged rather than discouraged. The bill should therefore distinguish between the dollar loans of the head office and American branches of a commercial bank and the foreign currency loans of the foreign branches of that bank, for the balance-of-payments consequences of the first are precisely the opposite of the second.

Unless the bill is changed, our foreign branches will be at a competitive disadvantage in foreign countries, because all of their term loans (presumably those 3 years and over) in foreign currencies would have to include a provision that the borrower pay any interest equalization tax found due. Our foreign competitors, whose loans could not possibly be subject to the tax, could make loans without such a provision.

This ambiguity in the bill could be cleared up if your committee were to add some such language as follows:

> Section 4914(b)(2)(c) of debt obligations by the foreign branches of a commercial bank in making loans in foreign currency.

A provision of this kind could not be subject to abuse because American banks do not risk converting dollars to make long-term loans in foreign currencies.

Yours sincerely,

WALTER B. WRISTON.

INTEREST EQUALIZATION TAX: A DECEPTIVE TOURNIQUET

Last month, the House of Representatives passed a bill providing for a tax on purchases of foreign securities by Americans. The bill now awaits hearings in the Senate Finance Committee. Although it is generally expected that the legislation will be passed, it may be worthwhile to have yet another look at a measure which even its advocates regard as undesirable as permanent legislation and which, in any event, is due for reconsideration by December 1965.

In spite of this lack of enthusiasm, the administration continues to urge the approval of the tax on the ground that failure to pass it might cast doubts upon U.S. willingness to reduce the large and stubborn balance-of-payments deficit. This effort places the main burden of redressing the deficit on cutting private investment abroad though such investment creates opportunities for U.S. exports and builds up valuable income-producing assets. Furthermore, it constitutes a departure from the principles of free international movement of capital—principles that the United States urges other nations to restore and respect because they make for a flourishing world economy.

The levy, it may be recalled, bears the title of "interest equalization tax" and is designed principally to check purchases of newly issued foreign bonds through raising interests costs by 1 percentage point for borrowers from the so-called developed countries. The legislation, which was proposed last summer when the balance of payments turned sharply for the worse, is to be applicable retroactively to July 19, 1963 (August 17 for securities listed on national exchanges).

While the tax is not law, it has—not unexpectedly—created so many uncertainties with regard to costs of raising funds in the United States that it has shut off practically all foreign bond purchases by Americans. Like the Emperor's new clothes in the fable, the tax does not exist but nobody can challenge its image.

RANGE OF POSSIBLE RESULTS

There is no sure way of estimating the possible results of the proposed tax. Judging by capital shortages throughout the world and by restrictions in London and continental capital markets, borrowers will undoubtedly continue to seek long-term money in the United States. To provide statistical background, the table sums up purchases by Americans of foreign bond issues over recent years by grouping borrowers according to their tax status under the contemplated legislation.

By far the biggest borrower at long term in the U.S. market is Canada. Within 48 hours following the administration's announcement of the proposed tax last July, Canadian officials asked for, and obtained, a general exemption for new issues on the grounds of special economic relationships between our two countries. This is to be done under a clause in the proposed legislation giving the President authority to provide exemption from the tax "where required for international monetary stability." As officially stated, only Canada today qualifies for exemption on these grounds—with the understanding that Canada will not increase its official monetary reserves through the proceeds of borrowings in the United States. As Canada will return to our capital market on an exempt basis, the whole scheme has lost much of its potential usefulness as a means of significantly reducing the volume of foreign bond issues.

Less-developed countries are also to be exempt from the tax; but—with the notable exception of Israel—they have raised long-term money in our market only sparingly. The World Bank and the Inter-American Development Bank are also exempt.

This leaves only developed countries other than Canada—i.e., mainly Western Europe and Japan—as the area where the tax deterrent might decrease bond sales significantly. Such issues—floated mostly by governments and semiofficial institutions—have gained U.S. investors' acceptance only in recent years. Admittedly, the future cannot be predicted solely on the basis of past experience. While the volume of such borrowings will, in all likelihood, recede from the high level of the first half of 1963, it is doubtful whether the net effect of the proposed tax will be substantial enough to warrant taking such a potentially harmful and unsettling step.

The proposed legislation also imposes a 15 percent tax on U.S. purchases of foreign stocks and other outstanding securities. Such purchases have never been a serious factor in our international payments.

CONTROL AND REGULATION

As originally conceived, the measure represented an intellectual attempt at interest equalization between our capital market and the principal centers abroad. It was to increase costs to foreigners of capital in the U.S. market without any need for U.S. financial authorities to interfere with market processes through controls over, or even the screening of, capital issues. Yet, as embodied in the actual draft legislation, the measure depends more upon controls over the transactions that are exempt from the tax than upon the tax itself. Of the 71 pages of H.R. 8000, as approved by the House, 50 pages are devoted to the listing of exemptions.

Some of these exemptions are to be provided for in the law. Thus, recognition is given to the importance of financing U.S. exports by exempting securities or commercial bank loans that mature in 3 years; recognition is also given to the foreign exchange earning power of oversea investments by American corporations by exempting direct investments. Many exemptions are, however, left to the discretion of the President and the Treasury Department. Thus, the tax, as proposed, would apply to 22 "developed" countries selected by the administra-

tion. For example, Portugal would be exempt, but not Spain; Finland but not Norway; the Philippines but not Hong Kong. The selection is subject to change by Executive order. Canada's exemption, noted above, also rests on the discretionary power of the President.

The exemption proposed for commercial banks is designed to make sure that credit "in support of normal and recurrent business operations abroad will not be unnecessarily impeded," to quote Treasury Secretary Dillon. The "possibility of abuse of this exemption" prompted the Treasury to seek and obtain an amendment to the legislation endowing it with specific authority to obtain from banks detailed reports of their foreign lending activity. The implied threat of taking away the exemption is expected to obtain voluntary compliance with official views.

The real effect of the proposed tax is thus control and regulation. Not surprisingly, some people have suggested that there is a better way to obtain the desired result—a voluntary capital issues committee acting on guidelines established by appropriate governmental agencies to screen foreign plans for borrowing in our market.

New issues of foreign securities purchased by Americans, grouped according to seller's status under the proposed tax

[In millions]

	1956–60 average	1961	1962	1963		
				January to June	July to December	Year
EXEMPT FROM TAX						
Canada	$346	$237	$457	$632	$104	$736
Latin America	24	18	102	12	23	35
Israel	50	58	60	35	33	68
World Bank [1]	133	12	84	0	0	0
Subtotal	553	325	703	679	160	839
SUBJECT TO TAX						
Western Europe	50	57	195	219	53	272
Japan	7	61	101	108	57	165
Australia, New Zealand, and South Africa	30	80	77	18	0	18
Subtotal	87	198	373	345	110	455
Total	640	523	1,076	1,024	270	1,294
Redemptions	127	123	170	83	67	150
Net total	513	400	906	941	203	1,144

[1] Includes, in 1962, issues of the Inter-American Development Bank.

Source :U.S. Department of Commerce, Survey of Current Business.

Those who regard a capital issues committee as a lesser evil than the proposed tax are aware of the drawbacks common to both: experience shows that "temporary" taxes as well as "temporary" controls tend to become permanent; even if things do not go well, the medicine is all right but just more of it is needed. In addition, one expedient often carries with it a whole sequence of further expedients, each with less justification than the last. The alleged advantage of the capital issues committee is its informality and flexibility.

The difficulty is that a capital issues committee would have to ward off the countless outside pressures which would be brought to bear on it as it performs the thankless task of deciding just how much portfolio investment abroad is sustainable. Such a committee, which would have to make judgments against the background of the country's delicate and complex international relations, could scarcely win many friends and might earn many enemies.

More fundamentally, tinkering with controls may well have unwanted consequences. As the former president of the New York Federal Reserve Bank Allan Sproul noted:

"We need to avoid experimenting with direct controls, whatever they may be called, which in times of strain may be interpreted as a forerunner of stronger

controls of capital outflow, or even of all dealings in foreign exchange, which in turn would heighten the danger of anticipatory withdrawals of foreign funds from our markets."

Investors abroad seek and trust bonds denominated in U.S. dollars. A considerable part of foreign dollar bonds issued in the United States has been sold to nonresidents. Since mid-1963, issues that otherwise would have been floated in New York have been carried through in European markets but it is the label "U.S. dollar" that makes them acceptable to investors. The smaller shrinkage of the purchasing power of the dollar and its greater freedom of use compared with many other major currencies have not remained unnoticed.

THE BROADER CONTEXT

In this whole context, it needs to be recognized that borrowings in the United States are attractive because long-term interest rates abroad, except in Switzerland, are higher than in our market. This is the result of the very abundance of U.S. savings, together with the reluctance of the administration to condone higher costs and lesser availability of credit. Yet, given the conditions in which the U.S. economy finds itself this year, interest rates may well tend to rise of their own accord. This would tend to slow up new borrowings, including new issues of foreign bonds. Now that tax relief has been given, materially higher interest rates need not darken the prospects of sustained business expansion. They need not restrain investment and output so long as profit incentives and profit expectations are encouraging.

It is neither necessary nor desirable to erect a wall around a particular sector of the U.S. capital market. Whenever Canada, Japan, and those Western European nations which are not dollar-rich sell bonds in the United States, the proceeds are used, directly or indirectly, to buy U.S. goods and services. Usually, there is a direct connection; trade follows credit.

The business community makes a strong contribution to our balance of payments. This is unmistakably evidenced by the surplus on merchandise account and the excess of remitted income over the net outflow of private capital for long-term investment abroad. U.S. Government policies to redress the balance-of-payments deficit should encourage this contribution, not hamper it, as does the proposed tax.

The interest equalization tax may well prove to be a deceptive tourniquet. Its enactment should serve as yet further evidence of the tendency for a persistent balance-of-payments deficit to corrupt the principles of a free international capital market. Government policy should serve not to postpone but to expedite action to deal with the payments deficit effectively and resolutely.

STATEMENT OF EDWIN D. ETHERINGTON, PRESIDENT OF THE AMERICAN STOCK EXCHANGE, REGARDING H.R. 8000, INTEREST EQUALIZATION TAX

The American Stock Exchange, as the foremost national securities exchange in trading common stocks of foreign issues, has a direct interest in the interest equalization tax as proposed in H.R. 8000. Since the volume of trading in foreign issues on the exchange dropped to 47 million shares (15 percent of the total) in 1963 from 56 million shares (18 percent of the total) in 1962, the impact of the proposal over the last 4½ months of 1963 was clear. The pattern of relatively depressed trading in these issues has continued in 1964.

It is sound policy for the United States to move toward freer trade and greater mobility of capital among countries. Progress toward these goals is increasingly urgent for the continuing growth of the interdependent economies of the free world. H.R. 8000, by tending to impede the free operation of this country's relatively friction-free capital markets, is inconsistent with the broad press of this Nation's efforts in international cooperation. The proposed tax would be a restrictive and at least partially self-defeating measure.

In contrast to the restrictive provisions of H.R. 8000, the proposals of the President's Task Force on promoting increased foreign investment, set forth in the report released on April 27, 1964, are affirmative and constructive. This group proposed a liberalization of capital movements throughout the world by the removal of exchange controls and by a relaxation of monetary, legal, institutional, and administrative curbs on capital flows. Fewer, not more, restrictions are needed.

The exchange recognizes the fact that voluminous statistical information has been placed before the Senate Finance Committee by a series of experts, all of whom—whatever their position on this proposal—share the administration's concern over the balance-of-payments problem. The purpose of this statement is to make the exchange's position clear in the hope that it will aid the committee as it seeks a final perspective on the wisdom of this particular approach to an admittedly difficult question of national policy.

The exchange submits the following points for your consideration:

1. The proposed bill is not addressed to the chief causes of the balance-of-payments deficit

The underlying assumption of H.R. 8000 is that private portfolio investment abroad is a major cause of this Nation's balance-of-payments deficit. In recent years, however, date compiled by the U.S. Department of Commerce indicate that private portfolio investment abroad has been relatively insignificant compared to such items as military expenses, unilateral transfers to foreign countries, tourist spending abroad, direct investments, and net U.S. Government long-term capital transfers. Accordingly, two critical weaknesses in the proposed bill are revealed:

First: Significant sources of capital flowing abroad are beyond the reach of the bill. The measure will not curb the dollar outflow stemming from direct investments abroad, U.S. Government long-term capital transfers and commercial bank loans—none of which as yet comes under the interest equalization tax. These exempted bank loans in particular have risen markedly in recent months.

Second: The proposed bill is necessarily made relatively meaningless because of the exemptions it properly contains. Canada, which has been the prime cause of the outflow of dollars for new foreign portfolio investment over the years will be exempt from the bill, thus reducing even further the limited scope of the measure. In the first quarter of 1963 Canada alone accounted for $348 of the $485 million portfolio outflow.

2. Enactment of this bill could adversely affect the U.S. balance of payments by creating fears of further restrictive measures

Even the most generous estimates indicate that H.R. 8000 will not solve the U.S. balance-of-payments problem. A Treasury Department projection foresees the bill reducing the outflow of capital to the $500 to $700 million range that prevailed in 1959–61. Compared to the $1.1 billion total outflow in 1962, a reduction of only $400 to $600 million in the overall deficit would be realized. However, if further effect is given to the exemption promised Canada, and if it is assumed that the dollar outflow to that country equals the 1962 figure of $457 million, a maximum reduction in outflow of only $143 million would be forthcoming.

Paradoxically, this bill could well aggravate the situation it is designed to remedy. If enacted, it could create fears abroad of further restrictive measures designed to curb the net outflow of dollars. Foreign investors own approximately $12 billion of U.S. securities. Should their concern, result in a weakening of foreign confidence in the U.S. dollar, it is conceivable that some foreign holders of U.S. securities would liquidate their positions. This would cause a further outflow of dollars. Conversely, the fears of some American investors about the value of the dollar could motivate them to buy more, rather than fewer, securities abroad. In either case, the U.S. balance-of-payments picture could deteriorate further, producing an effect opposite from the one intended. These are the hazards of a restrictive, as opposed to an affirmative, policy.

3. The proposed bill overlooks the fact that foreign investments produce a considerable part of U.S. income from abroad

President Kennedy, in his special message to Congress on the balance-of-payments problem, stated that U.S. income from foreign investment amounted to $4.3 billion in 1962. He further stated that we can expect "further substantial increases in the coming years in U.S. income from these investments."

If this bill achieved its intended result of discouraging American investment abroad, the significant anticipated increases in income surely would not be forthcoming. Moreover, American owners of foreign securities might be tempted to sell their holdings for fear of retaliatory measures by foreign countries. As a result, the funds now flowing into the United States through foreign investments would decline. Accordingly, if the bill were enacted, the growth of U.S.

income from foreign investments might be curtailed and the balance of payments adversely affected.

In most of the years since World War II, foreigners have been substantial net buyers of U.S. corporate securities. Thus the flow of capital is not all one way. In addition, through short-term investment of its large dollar earnings, Western Europe has put more capital into the United States than it has taken out through long-term borrowing.

It may be that further study of the proposals of the President's Task Force, as noted above, will indicate areas where legislation could substantially ease the balance-of-payments problem without the potential far-reaching consequences of H.R. 8000. Before adopting any proposal raising fears on the part of investors and adversely affecting U.S. foreign investment income, Congress should satisfy itself that the bill's long-range impact will not worsen rather than improve our balance of payments.

4. Exemption for outstanding securities

The proposed tax is to be applicable to the acquisition of both new and outstanding securities. The Treasury Department, while observing that the major problem area is in the issuance of new securities—in 1962 the dollar outflow resulting from new issues of foreign securities amounted to $1.076 billion as compared to $55 million from outstanding securities—feels that an exemption for outstanding securities would sharply reduce the effectiveness of the tax because American investors would shift their interest to outstanding foreign securities. This reason discounts two important factors. First, American investors are not likely to purchase outstanding foreign securities solely because they are exempt from the tax. Whatever temporary buying pressure might initially exist would cause the price of the security to rise to a level that would soon be unattractive. Second, a significant percentage of outstanding foreign securities, at least those traded on the two principal stock exchanges in New York, are already owned by Americans. Thus any sale by an American would not be subject to the tax and would not adversely affect the balance of payments.

It seems unlikely that an exemption for outstanding securities would materially reduce the limited effectiveness of the proposed tax. Moreover, foreigners' net purchases of outstanding U.S. corporate securities have traditionally exceeded American purchases of outstanding foreign securities, thus producing a net inflow of dollars to the United States. Accordingly, if H.R. 8000 is enacted, Congress should provide an exemption for outstanding foreign securities.

CONCLUSION

The provisions of section 4918(c), developed with the Treasury Department to assure the continued efficient operation of national securities exchanges, as included in the version of this bill approved by the House of Representatives, are critical elements of the bill. Moreover, an exemption for outstanding securities, in view of the fact that the major problem area lies in the new issues field and trading in outstanding securities has traditionally produced a net inflow of dollars to the United States, would be in the national interest. The essential position of the exchange, however, is that the bill should not be enacted.

(Whereupon, at 12:05 p.m., the committee was in adjournment.)

88TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
1st Session } { No. 1046

INTEREST EQUALIZATION TAX ACT OF 1963

DECEMBER 16, 1963.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. MILLS, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 8000]

The Committee on Ways and Means to whom was referred the bill (H.R. 8000) to amend the Internal Revenue Code of 1954 to impose a tax on acquisitions of certain foreign securities in order to equalize costs of longer term financing in the United States and in markets abroad, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment appears in italic type in the bill herewith reported to the House.

I. SUMMARY

H.R. 8000, as reported, provides an interest equalization tax designed to bring the cost of capital raised in the U.S. market by foreign persons more closely into alinement with the costs prevailing in markets in other industrial countries. The tax is designed to aid our balance-of-payments position by restraining the heavy and accelerated demand on our capital market from other industrialized countries. The interest equalization tax is a temporary excise tax effective for the period July 19, 1963 (August 17, for listed securities) through December 31, 1965.

The bill imposes the tax on the acquisition by a U.S. person of a debt obligation of a foreign obligor, or stock of a foreign issuer, which is acquired from a foreign person. The tax on the transfer of stock is 15 percent of the actual value of the stock at the time of the transfer. The tax on the transfer of debt obligations varies from 15 percent on obligations with a maturity of 28½ years or more down to 2.75 percent for those with a maturity of 3 to 3½ years. For debt obligations with a shorter maturity, no tax is imposed.

99-006—63——1

These tax rates are designed to reduce the net rate of return to the U.S. buyer on the foreign securities involved by about 1 percent per annum, in order to decrease the volume of foreign securities sold in the U.S. market. It is anticipated that this may well improve the U.S. balance of payments by from $1.25 to $1.5 billion a year relative to the rate in the first 6 months of 1963. It is expected to increase revenues by up to $30 million a year.

The principal exclusions in the bill relate to—

(1) Securities acquired from a prior American owner;

(2) Securities received in connection with a wide range of export transactions;

(3) Debt obligations received by commercial banks in the course of their commercial banking business;

(4) Direct investments in 10-percent-owned corporations;

(5) Securities of "less-developed-country corporations" and obligations of less-developed countries;

(6) New security issues which the President exempts in the interest of international monetary stability, presumably new Canadian securities;

(7) Reserves maintained by insurance companies doing business in foreign countries; and

(8) Investments of foreign membership dues by labor unions and other exempt organizations.

The administration has strongly urged the adoption of this bill as an essential part of the overall program to reduce the balance-of-payments deficit.

II. REASONS FOR THE BILL

As indicated in table 1, the U.S. balance of payments has consistently been in a deficit position since 1957, and with the exception of the year 1957, has been in a deficit position since 1949. The deficits attributable to the last 6 years have given rise to a depletion of the U.S. gold reserve of over $7 billion.

TABLE 1.—*U.S. balance of payments annually for the period 1949–62, and quarterly for 1962 and 1963 to date*

[In millions of dollars; quarterly figures seasonally adjusted annual rates]

1949	175	1961	−2,370
1950	−3,580	1962	−2,186
1951	−305	1962:	
1952	−1,046	I	−2,340
1953	−2,152	II	−1,808
1954	−1,550	III	−1,424
1955	−1,145	IV	−3,172
1956	−935	1963:[1]	
1957	520	I	−3,460
1958	−3,529	II	−4,956
1959	−3,743	III	−1,024
1960	−3,881		

[1] Excludes receipts from sales of nonmarketable, medium-term convertible Government securities.

Source: U.S. Department of Commerce.

Thus, on an annual basis the peak deficit in the overall U.S. balance of payments of $3.9 billion was reached in 1960. Since that time, the overall deficit has gradually declined to a level of $2.2 billion in 1962. However, late in 1962 the deficit in the balance of payments started to rise again and this trend continued through the first half of 1963.

As indicated in table 1, the overall deficit in the balance of payments in the fourth quarter of 1962 was $3.2 billion and in the first quarter of 1963 was $3.5 billion (both figures are seasonally adjusted annual rates). Then in the second quarter of 1963, this increased to $5 billion on an annual rate basis. This worsening of the balance-of-payments position occurred despite arrangements for the advance payment of debt owed the United States by various foreign countries, despite progress in reducing net Government outlays of dollars abroad and also despite efforts over that period by the administration to bring upward pressures on short-term interest rates and thus encourage the retention of funds seeking short-term investment in this country.

The trend in the balance of payments in recent years can more accurately be seen by examining the balance on regular transactions.[1] These data are shown in table 2. They indicate that the deficit on regular transactions in 1962 was in excess of $3.5 billion, or more than

[1] This includes all regular reoccurring transactions, including those involving the Government, but does not include nonscheduled repayments of Government loans, advances from other countries on military exports, and other special measures taken to reduce the financial burden of the deficit, such as medium-term borrowings.

$500 million above the deficit in 1961. Moreover, the deficits of $973 million and $1,258 million in the first two quarters of 1963, respectively, when converted to an annual rate, suggest a deficit in these regular transactions of approximately $4.5 billion for the first 6 months of the year. Table 2 indicates that the major factor in this worsening of the balance-of-payments position is the outflow of private long-term capital. The net outflow of this capital increased over $300 million from 1961 to 1962. Moreover, the experience of the first two quarters of 1963 suggests that private long-term capital outflows could be expected to reach an annual rate of $3.5 to $4 billion, further increasing the outflow of long-term capital more than $1.25 billion above the 1961 level.

TABLE 2.—*U.S. balance of payments, 1960 through 3d quarter 1963*

[In millions of dollars]

	1960	1961	1962	1963 [1]		
				1st quarter	2d quarter	3d quarter
Commercial trade balance	2,817	3,179	1,089	402	497	530
Commercial services balance	1,458	2,130	2,322	615	481	585
Balance on commercial goods and services [2]	4,275	5,309	4,311	1,017	978	1,115
Military expenditures	−3,048	−2,934	−3,028	−748	−725	−707
Military cash receipts [3]	836	393	673	184	197	171
Government grants and capital-dollar payments to foreign countries and international institutions	−1,107	−1,116	−1,070	−241	−267	−179
Government capital receipts, excluding debt prepayments, borrowings, and fundings [4]	538	533	513	102	120	166
Remittances and pensions	−672	−705	−736	−212	−209	−193
Private capital:						
Long-term	−2,114	−2,143	−2,495	−1,022	−901	−482
Short-term	−1,438	−1,475	−716	69	−593	31
Unrecorded transactions	−683	−905	−1,025	−122	142	−334
Balance on regular transactions	−3,913	−3,043	−3,573	−973	−1,258	−412
Special Government transactions [5]	32	673	1,387	458	171	331
Overall deficit	−3,881	−2,370	−2,186	−515	−1,087	−81

[1] Seasonally adjusted but not annual rates.
[2] Nonmilitary merchandise and service transactions less those financed by Government grants and capital.
[3] Excluding advances on military exports.
[4] Includes small changes in miscellaneous Government nonliquid liabilities.
[5] Not seasonally adjusted. Includes nonscheduled receipts on Government loans, advances on military exports, and sales of nonmarketable medium-term securities, including $350,000,000 of nonmarketable medium-term convertible securities in the 1st quarter of 1963, $152,000,000 in the 2d quarter of 1963 and $175,000,000 in the third quarter.

Source: Survey of Current Business.

One of the major factors in the increase in long-term private capital outflow has been the very substantial rise in new issues of foreign securities purchased by U.S. residents. As indicated in table 3, these new issues of foreign securities purchased by U.S. residents increased from $523 million in 1961 to $1,076 million in 1962, an increase of over $550 million. Moreover, the experience in the first two quarters of 1963 would suggest purchases of these securities at an annual rate of about $2 billion. Thus, in this period since 1961 the rate of purchases of these new issues of foreign securities doubled relative to the volume of purchases in the prior year. As indicated by table 3, the great bulk of these new securities issues originated in Canada, Western Europe, and Japan.

TABLE 3.—*New issues of foreign securities purchased by U.S. residents, 1961 to 3d quarter, 1963* [1]

[In millions of dollars]

	Total 1961	1962					1963		
		I	II	III	IV	Total	I	II [2]	III [3]
Canada	237	10	112	41	294	457	368	264	79
Western Europe	57	35	138	15	7	195	65	154	14
Japan	61	11	17	48	25	101	42	65	52
Latin American Republics	18	(4)	19	(4)	[5] 83	[5] 102	12	------	23
Other developed countries	43	(6)	(6)	(6)	(6)	60	------	17	------
Other less developed countries	95	(6)	(6)	(6)	(6)	77	19	17	11
International institutions and unallocated	12	80	1	3	------	84	------	------	------
Total new issues	523	170	312	133	461	1,076	506	518	179

[1] Not seasonally adjusted.
[2] Revised.
[3] Preliminary.
[4] Less than $500,000.
[5] Includes $75,000,000 issue by Inter-American Development Bank.
[6] Not available.

Source: Survey of Current Business and Department of Commerce.

In addition to new foreign securities floated in the United States, the large volume of outstanding foreign securities sold in the United States also has been an important factor in accounting for the deficit in the balance of payments. United States net purchases of outstanding foreign securities in recent years, and by quarters (not enlarged to annual rates) for 1963, are as follows:

Net purchases of outstanding foreign securities

[In millions of dollars]

1959	−140
1960	−177
1961	−353
1962	−55
1963 (1st quarter)	−48
1963 (2d quarter)	−64
1963 (3d quarter)	+51

The substantial improvement suggested by these figures for 1962, before the announcement of the tax, was centered in transactions in foreign stocks, as shown by table 4. In good part, this appears to have reflected some temporary factors. The available data do not permit a precise analysis of the transactions of U.S. persons with foreigners since the figures are collected only for purchases and sales of foreign securities in the U.S. market, whether or not the transactions are with Americans or other foreigners. But it appears that despite the relatively small net sales of foreign stock in the U.S. market in 1962, Americans remained large buyers of some foreign stock, while apparently increasing their sales to foreigners of foreign stock purchased at an earlier time. The size of these gross purchases and sales is suggested by table 4. The tax should substantially reduce gross sales by foreigners to U.S. purchasers without at the same time affecting incentives to sell other foreign securities, already held by Americans, to foreigners. This could have a substantial favorable effect on the balance of payments, turning what could otherwise be a major net minus factor in the balance of payments to a plus factor, as happened in the third quarter of 1963.

In addition to the direct improvement in the balance of payments anticipated from including within the tax base outstanding foreign securities, it is believed essential to cover these securities in any provision which taxes new foreign issues. If these issues are not subject to the tax, it could be expected that much of the improvement in the balance of payments brought about by taxing acquisitions of new issues would be offset by much larger acquisitions by U.S. persons of outstanding foreign issues. To the extent that sales of outstanding issues are diverted to the United States, the opportunity for selling new issues in the foreign market is improved, thereby achieving much the same result as if the new issues were initially sold in the United States.

TABLE 4.—*Gross transactions in outstanding foreign bonds and stocks, 1960 through 1st half 1963*

[In millions of dollars]

Period	Outstanding foreign bonds			Outstanding foreign stocks		
	Gross sales by foreigners [1]	Gross purchases by foreigners [2]	Net purchases by Americans (−)	Gross sales by foreigners [1]	Gross purchases by foreigners	Net purchases by Americans (−)
1960	−771	669	−102	−575	500	−75
1961	−624	597	−27	−919	593	−326
1962	−782	753	−29	−721	695	−26
1963:						
1st quarter	−175	126	−49	−166	167	1
2d quarter	−175	117	−58	−197	191	−6
1st half	−350	243	−107	−363	358	−5
3d quarter	−248	282	34	−116	133	17

[1] Excludes new issues sold by foreigners to U.S. residents or other foreigners, and adjustment for direct investment transactions.

[2] Excludes redemptions of bond issues held by U.S. residents and other minor differences between security-transaction and balance-of-payments data.

Source: Unpublished balance-of-payments data from Commerce Department.

In the third quarter of 1963—most of which followed the announcement of the tax—table 4 indicates that the net purchases of foreign stocks and bonds result in a favorable balance of $51 million, which converts to an annual rate of $204 million. This can be contrasted to the unfavorable balance in 1962 of $55 million, a difference in the balance-of-payments position of $259 million. The comparable gain from the second quarter to the third was an improvement at an annual rate of more than $450 million.

There are no signs that the flood of new securities issues which occurred up through the second quarter of 1963 would of its own accord fall back to the more sustainable levels of earlier years. Similarly, there is no indication that the purchases of outstanding issues by Americans could be expected to decline in the absence of legislation in this area. Foreign businessmen and foreign local governments are becoming more aware of the efficient marketing facilities and also the relatively low rates of interest available here, and are learning how to place securities in the U.S. market. Moreover, as production costs rise in the European market, business firms are finding it more difficult to finance their growth from retained earnings. Thus they can be expected to be in the market for increased funds.

The European markets still are not adequately organized to efficiently supply business needs or the borrowing requirements of their governments from the growing savings of their own people, and as a result, foreign enterprises and governments, in the absence of a change in capital costs, can be expected to look toward the United States for these funds.

Similarly, U.S. underwriters are becoming more familiar with foreign securities. Moreover, American investors have become more interested in foreign issues because of the large volume of these securities now being offered in this country, and because the rate of return on these securities, relative to the domestic investment outlets, makes them highly attractive. The unfortunate experience of the 1920's and 1930's, which in the past has restrained the demand for foreign securities, now appears to have been largely forgotten. In addition, the more ready convertibility of currencies in recent years has lessened the fear of difficulty in obtaining payment in the United States of income and principal on these securities.

This bill deals with this problem of excess sales of foreign securities here in the United States by imposing a tax, called the interest equalization tax, on the acquisition by a U.S. person of a foreign security from a foreign person. In the case of stocks, this tax is 15 percent of the actual value. In the case of bonds, the tax is graduated by the remaining length of time to the maturity of the bond, varying from 2.75 percent for bonds with a period of maturity of 3 to 3½ years (those with a period of less than 3 years are exempt) to the same 15 percent rate applicable to stocks in the case of bonds with a period to maturity of 28½ years or more. The schedule of rates applicable to bonds is calculated to be the equivalent to raising the interest rate in the U.S. market by 1 percent. Since the sale of stock is, of course, an alternative way of raising capital for foreign corporations, the tax is applied to equities in a manner which will have a comparable effect on the costs of raising capital by this means.

Looked at from the standpoint of an American contemplating the purchase of an outstanding security from a foreign person, the interest equalization tax will reduce the yield of that security by about 1 percent, making the yields available on alternative domestic investment relatively more attractive. Looked at from the standpoint of foreign persons raising new money, the interest equalization tax will raise the cost of obtaining capital in the U.S. market by approximately this same 1 percent.

The interest equalization tax is expected to raise the cost of obtaining capital in the U.S. market to more nearly the cost prevailing in most of the industrialized countries abroad. In only two countries, Switzerland and the Netherlands, are long-term interest rates below, or comparable with, those presently prevailing in the United States. However, these countries limit by direct controls the amount of foreign borrowing which can occur in their markets. This is also true of the United Kingdom, which has the largest of the foreign markets. The United Kingdom until quite recently confined its lending almost entirely to Commonwealth countries in the sterling area. This is true even though in the United Kingdom the prevailing interest rate already is 1 percent or more above the rate prevailing in the United States.

The higher cost to foreign persons of obtaining funds in the United States as a result of this tax will not prevent the floating of new

issues, or the sale of outstanding issues in this country. With the tax in effect normal market factors will continue to determine which issues will be marketed in the United States. However, the bill will stop the drain of funds from this country by foreign borrowers who are motivated merely by the fact that long-term funds may be obtained here at a slightly lesser interest rate than generally prevails abroad.

Of course, much the same results could be obtained by raising the long-term interest rate by 1 percent or more in the United States. To achieve such a rise of long-term rates in a market which characteristically supplies many times as much capital for domestic uses as for foreign, would under present circumstances not only be very difficult but also unwise. Long-term interest rates have remained relatively steady over the past 3 years, despite rising demands for funds, because of the substantial ability of this Nation to generate liquid savings. In this environment, monetary policy or the use of other powers of the Government evolving within free markets would not be capable of bringing about a change in interest rates of sufficient size to effect a substantial reduction in the flow of funds abroad. Certainly, attempts to achieve this result would have a restrictive effect on new domestic investments at the very time additional investments are required in this country to bring about a higher rate of growth.

This tax is imposed as a temporary tax effective only through 1965. It is a part of the broader attack on the balance-of-payments problem, which includes both short- and long-run measures dealing with all items affecting the balance of payments. On one hand, it is is anticipated that the profitability and attractiveness of domestic investment will be improved as a result of the tax reduction program already passed by the House; and, on the other hand, it is anticipated that as the capital markets in other industrialized countries abroad become more efficient and are freed of controls, they will supply a larger share of the world's capital requirements. The termination of the tax at the end of 1965 will give Congress an opportunity to review all of the relevant considerations at that time, when it is hoped these readjustments in savings and investment patterns and improvements in the U.S. balance of payments will make it unnecessary to continue this tax.

The tax is effective with respect to transactions occurring on or after July 19, 1963, which was the day after the administration proposed the tax, and the date on which it was recommended that the bill become effective. Your committee believes that it is necessary to make the tax effective as of that date. To do otherwise, would have invited a flood of transactions in foreign securities after the announcement of the proposal, but before the effective date. This, of course, would have substantially worsened the balance-of-payments position. However, for securities listed on national exchanges the effective date was made August 17, 1963, in order to give the exchanges an opportunity to adjust to the new procedures.

As a result of this announcement's effect, the interest equalization tax has already played an important part in reducing the outflow of capital and in improving our overall balance-of-payments position.

As indicated by table 2, the outflow of U.S. capital in the form of new issues of foreign securities decreased from levels of $506 million and $518 million consecutively in the first two quarters of 1963 to $179 million in the third quarter. The experience in outstanding

foreign stocks and bonds purchased by Americans in this period is similar (see table 4). In the first half of 1963, net purchases by Americans of outstanding foreign stocks and bonds amounted to $112 million. On an annual rate basis this represents an unfavorable balance of $224 million. In the third quarter, there was a favorable net balance of $51 million, or, on an annual rate basis, a favorable net balance of $204 million. This is a change from the experience in the first half of over $400 million.

This dramatic improvement in the balance of payments is a concrete demonstration of the effect that this bill can be expected to have. The Treasury Department has estimated that this bill will result in an improvement in the balance of payments of $1¼ to $1½ billion from the rate in the first 6 months of 1963. This is suggested from the changing pattern of U.S. transactions in foreign securities in the third quarter relative to the first half of this year. Table 5, which shows selected capital movements in 1962 and in the first three quarters of 1963 on an annual rate basis, demonstrates the basis for this expectation. This table shows that the purchase of new issues of foreign securities in the third quarter of 1963 was at an annual rate of approximately $1.1 billion below the level of purchases of these securities in the first half of the year. In addition, the table shows that net U.S. purchases of outstanding foreign securities have between the first half and the third quarter of 1963 changed from an unfavorable balance of $224 million to a favorable balance of $204 million. This is an overall change in the balance-of-payments position of over $400 million. The combined savings in the balance of payments for these two categories, therefore, is $1.5 billion. While it is recognized, of course, that uncertainties related to the imposition of the tax may have restrained new lending during the third quarter, it should also be noted that the sizable volume of new issues reaching the market during that period reflected a working off of the large backlog of new issues for which commitments had been made prior to the announcement.

TABLE 5.—*U.S. balance of payments—Selected capital movements and deficit on regular transactions, 1962 to 3d quarter 1963*

[Seasonally adjusted annual rates; in millions of dollars]

	Full year 1962	1963		
		1st half	2d quarter	3d quarter [1]
Selected capital movements:				
U.S. transactions in foreign securities:				
New issues	−1,076	−1,922	−1,944	[2] −852
Redemptions	170	166	208	96
Other U.S. purchases (−) or sales (+)	−55	−224	−256	204
Total foreign securities	−961	−1,980	−1,992	−552
Bank credits to foreigners:				
Long-term	−117	−318	−708	−572
Short-term	−277	−772	−1,960	8
Total bank credit	−394	−1,090	−2,668	−564
Foreign purchases (+) or sales (−) of U.S. securities	+134	+294	+532	+144
Total securities and bank credit	−1,221	−2,776	−4,128	−972
Balance-of-payments deficit on regular transactions	−3,573	−4,462	−5,032	−1,648

[1] Preliminary.
[2] Reflects almost entirely commitments made before July 18.

Source: Commerce Department.

The period which elapsed after July 18 and before your committee acted to report this bill has made it possible to observe the effects this tax could be expected to have on various groups in the United States. This has demonstrated areas in which the original recommendation of the Treasury Department would have created hardships and inequalities. This period of approximately 4 months has made it possible for your committee to make adjustments to the originally proposed bill to alleviate these hardships and inequalities while at the same time maintaining the basic concepts of the bill as recommended by the administration. The various exemptions provided, including those for export paper, commercial bank loans, and short-term paper, will assure that our export effort and the normal recurring financing of international business will not be hampered. These exemptions are explained in the general explanation which follows.

III. GENERAL EXPLANATION

a. Imposition of tax

This bill, subject to specified exemptions, imposes a tax on the acquisition by U.S. persons of foreign securities from a foreign person. It does not apply to purchases of foreign securities by U.S. persons from other U.S. persons. To the extent practicable, the application of the tax is limited to the area of long-term investment, which in recent years has had an adverse effect on the U.S. balance of payments.

1. *Rate of tax.*—A tax of 15 percent of the actual value is applied to the acquisition by a U.S. person of stock of a foreign issuer. In the case of the acquisition of a debt obligation of a foreign obligor, the tax is determined on the basis of the length of time remaining to maturity of the obligation at the time acquired by a U.S. person in a taxable transaction. The tax rate increases as the period remaining to maturity of an obligation increases. No tax is imposed where the period to maturity is less than 3 years. The tax rates applied are designed to have the effect of increasing a foreigner's cost of raising capital in the United States by approximately 1 percent a year. The schedule of rates is as follows:

If the period remaining to maturity is—	The tax, as a percentage of actual value, is—
At least 3 years, but less than 3½ years	2.75 percent.
At least 3½ years, but less than 4½ years	3.55 percent.
At least 4½ years, but less than 5½ years	4.35 percent.
At least 5½ years, but less than 6½ years	5.10 percent.
At least 6½ years, but less than 7½ years	5.80 percent.
At least 7½ years, but less than 8½ years	6.50 percent.
At least 8½ years, but less than 9½ years	7.10 percent.
At least 9½ years, but less than 10½ years	7.70 percent.
At least 10½ years, but less than 11½ years	8.30 percent.
At least 11½ years, but less than 13½ years	9.10 percent.
At least 13½ years, but less than 16½ years	10.30 percent.
At least 16½ years, but less than 18½ years	11.35 percent.
At least 18½ years, but less than 21½ years	12.25 percent.
At least 21½ years, but less than 23½ years	13.05 percent.
At least 23½ years, but less than 26½ years	13.75 percent.
At least 26½ years, but less than 28½ years	14.35 percent.
28½ years or more	15.00 percent.

The equivalence of the tax to an interest rate increase of 1 percent for foreign borrowers can be illustrated by the following example. Assume that prior to the imposition of the tax a foreign borrower and a U.S. borrower could each obtain $100,000 in the United States for a 10-year period at an interest rate of 5 percent payable annually. Thus, each would pay $50,000 in interest spread over the life of the loan for use of the $100,000. Under the bill, the domestic borrower could continue to borrow on the same basis. However, since the American purchasing the debt obligation from the foreign borrower would also have to pay a tax of $7,700 (7.7 percent rate for debt with a maturity of 9½ to 10½ years), presumably the foreign borrowers in

order to raise funds in competition with American borrowers would have to reimburse the lender for the tax. One way of doing this would be to ask the borrower to pay a higher interest rate. Had he been required to pay a 1-percent higher interest rate, spread over the 10-year period, he would have paid $10,000 additional. The $7,700 in tax, all of which would have to be paid at the beginning of the 10-year period, is approximately the present value of ten $1,000 payments spread over the period of the life of the obligation when discounted at about the prevailing rate for foreign securities. The tax passed onto the borrower, therefore is about the equivalent of an increase in the interest rate of about 1 percent.

The bill provides no tax on the acquisition of debt obligations having less than 3 years remaining to maturity from the date of acquisition. Interest rates for short-term loans in the United States can more readily be influenced by monetary policy, when appropriate, and have been brought into closer alinement with those prevailing in most important industrialized countries abroad. Moreover, this exemption will permit the wide variety of transactions relating to international trade to proceed unhampered. Although your committee is aware of the fact that the exclusion of short-term loans from tax could shift foreign long-term borrowers into the short-term money market, it appears unlikely that this effect will occur to an important extent.

Under the bill, debt obligations which are convertible into stock over more than a 5-year period will initially be taxed as debt obligations. However, at the time they are converted into stock, they will be subject to an additional tax equal to the full 15-percent rate which would have been paid if they initially had been stock, reduced by the tax previously paid by the person making the conversion. Where the debt instrument may be converted into stock only within 5 years of the date of issuance, the instrument is treated under the bill as initially being stock and at that time subject to the 15-percent tax.

Your committee concluded that a debt obligation which could be converted into stock over an extended period of time (more than 5 years) should be basically treated as a debt obligation for purposes of the interest equalization tax. Since the interest equalization tax is imposed only for a short period (namely, through December 31, 1965) it was believed that these obligations would in all likelihood be acquired primarily for their debt features. However, your committee recognized that the treatment of all convertible instruments as debt obligations would create a possibility of avoidance whereby foreign persons could issue short-term debt instruments whose principal attraction would be the combination of a low tax rate with favorable conversion features that would be exercised shortly after the termination date of the interest equalization tax. Therefore, your committee's bill treats those obligations which must be converted over a relatively short period of time into stock in the same manner as if they initially were stock issues. On the other hand, longer term convertible debt obligations are so treated only if actually converted during the period of time when the tax is in effect.

2. *Persons liable for tax.*—The person acquiring the obligation of a foreign issuer or obligor is subject to tax if this person is a "U.S. person;" i.e., a citizen or resident of the United States, a domestic partnership, a U.S. estate or trust, or a domestic corporation. Acquisitions made by a State of the United States or by an agency, instrumentality, or political subdivision of a State, are also subject

to tax. In addition, corporations created or organized under the laws of the Commonwealth of Puerto Rico or the Virgin Islands or other possessions of the United States are treated as U.S. persons. Thus, for example, acquisition of foreign stock or debt obligations by Puerto Rican corporations will be subject to tax, but acquisitions of the stock or debt obligations of Puerto Rican corporations by citizens or residents of the United States will be exempt.

3. *General application of tax.*—In general, the tax applies whenever a U.S. person acquires ownership of stock or debt obligations of a foreign issuer or obligor from a foreign person. Under this general rule, transfers which are not considered to represent a real change in ownership are not to result in the imposition of the tax. For example, transfers between a person and his nominee, custodian, or agent are exempt from tax, as are transfers from a decedent to his executor or administrator. In addition, transfers to a survivor upon the death of a joint tenant, from a minor to his guardian, and other similar transfers by operation of law, are exempt from tax. The bill also provides that the receipt of stock or debt obligations of a foreign issuer or obligor by an individual citizen or resident of the United States as a gift is not subject to tax. Your committee also provided that acquisitions resulting from corporate distributions, liquidations, and reorganizations would generally be exempt from tax since such transfers generally involve neither a substantial change of position nor an outflow of U.S. dollars. Finally, the receipt of a stock option or similar right by a U.S. person for any reason connected with his employment by a foreign corporation will not be subject to tax if the right is nontransferable, otherwise than by will or the laws of descent and distribution, and is exercisable during the optionee's lifetime only by him.

4. *Limitations on amount of tax.*—The bill contains a special rule for the computation of tax where stock or a debt obligation is acquired as the result of the surrender of another debt obligation, the extension or renewal of a debt obligation by action by the obligee, or the exercise of an option or right to acquire stock or debt obligations. In general, the tax in these cases is equal to the regular tax reduced by the tax which would have been payable had the option, right, or debt surrendered, exercised, extended, or renewed been taxed at that time. In these cases the option, right, or debt obligation involved represents a value the American already had. Where a foreign corporation issues rights to its shareholders which permit the shareholders to subscribe to additional shares of the corporation, the tax is based upon the subscription price.

b. Exemptions from the tax

The bill provides for exemptions for various transactions in order to avoid creating unnecessary hardship and imparing normal commercial transactions, as well as to avoid conflicting with other important national objectives such as the promotion of our export trade and our assistance to the less developed countries of the free world. The principal exemptions provided are described below.

1. *International monetary stability.*—Your committee believes that it is desirable to enable the President of the United States to exempt new security issues of a foreign country from tax where he determines that application of tax to such securities imperils, or threatens to imperil, the stability of the international monetary system. This is in accordance with the treaty obligation of the United States to the Interna-

tional Monetary Fund. This obligation requires the United States "* * * to collaborate with the fund to promote exchange stability * * *."[1]

Your committee has received assurances from the Secretary of the Treasury that, under present circumstances, new issues of Canadian issuers and obligors are the only securities which he would recommend that the President exempt from tax. Moreover, it is the intent of your committee that the exemption of Canadian securities should be contingent upon Canadian borrowings returning to their historical levels and that the exemption should be revoked or limited if Canadian borrowings exceed amounts required to maintain their international reserves and reach the abnormal levels attained in 1962 and the first 6 months of 1963. It is understood that the Canadian Government, through its own interest rate policy or otherwise, will maintain borrowings by Canadians in the United States only to the extent necessary to permit Canada to attain an equilibrium in its reserve position. Therefore, should the Canadian balance-of-payments position improve as a result of recent Government policies to increase exports, it is expected that the need for Canadian borrowing in the United States will be reduced. Your committee has also been assured that the administration will follow the volume of Canadian borrowing in U.S. markets closely. Should the total of such borrowing exceed prudent limits, the President will have discretionary authority to impose a limitation on the volume of such exempt borrowings. This discretionary power to limit the size of any exemption gives assurance that the Canadian exemption will not undermine the purpose of this tax. Your committee believes that the Canadian-United States relationship with respect to the close integration of their capital markets and its implications for the Canadian balance of payments is unique, and that exemption of new issues of Canadian securities under this discretionary provision should not under normal circumstances be extended to securities of other countries.

The bill provides that the exclusion is to apply only to original or new issues. A debt obligation is treated as part of an original or new issue for this purpose only when it is acquired during the first 60 days after interest begins to accrue on the obligation. Stock is treated as part of an original or new issue only when it is acquired from the issuer by the U.S. person claiming the exclusion.

If the President by Executive order limits the amount of issues which may be exempt, or limits the period during which the issues may be exempt, the exclusion is to apply to those as to which notice of acquisition is filed first with the Secretary of the Treasury.

2. *Less developed countries.*—The bill provides that the tax is not to apply to acquisitions by U.S. persons of (1) debt obligations issued or guaranteed by a national or local government of a less developed country, (2) stock or debt obligations of a "less developed country corporation," or (3) a debt obligation issued by an individual or partnership resident in a less developed country in return for property which is used, consumed, or disposed of wholly within one or more less developed countries.

This exclusion is designed to avoid cutting down the flow of private capital to those nations with chronic capital shortages, urgent devel-

[1] Articles of agreement between the United States of America and other powers respecting the International Monetary Fund, Bretton Woods Agreement, art. IV, sec. 4(a).

opment needs, and limited capability for foreign borrowing on normal commercial terms. The United States has long recognized a responsibility for assisting these nations in their struggle to achieve improved standards of living, and the application of the tax to issues of these countries would work against that objective. Furthermore, the outflow of portfolio capital to these areas has been limited, never exceeding $200 million during recent years, and usually running closer to $100 million.

The bill permits the President to designate any country other than the following as less developed countries:

Australia
Austria
Belgium
Canada
Denmark
France
Germany (Federal Republic)
Hong Kong
Italy
Japan
Liechtenstein
Luxembourg
Monaco
Netherlands
New Zealand
Norway
Republic of South Africa
San Marino
Spain
Sweden
Switzerland
United Kingdom
Countries within the Sino-Soviet bloc

The President may designate an overseas territory, department, province, or possession of any foreign country as a separate economically less developed country. Until the President designates countries as being economically less developed for purposes of this tax, all countries, other than those listed above, are to be treated as economically less developed and all overseas territories, departments, provinces, and possessions of any foreign country outside the Sino-Soviet bloc are considered to be separate less developed countries. Once the President initially designates a foreign country as being economically less developed for purposes of this tax, he may not terminate such designation without notifying the Congress of his intention to do so.

3. *Direct investments.*—The bill provides that the tax is not applicable to direct investments. Direct investment implies active participation in the management of the foreign corporation. Decisions to make investments of this type largely are concerned with questions of market position and long-range profitability rather than interest-rate differentials. Your committee believes that application of this bill, which is intended to equalize costs as between capital markets, is not appropriate in that area.

The bill defines as direct investments exempt from tax those acquisitions by a U.S. person of stock or debt obligations of a foreign issuer or obligor where immediately after the acquisition (or at the end of that year) the U.S. person owns 10 percent or more of the combined voting power of all classes of stock of the foreign corporation. In determining whether or not a person owns 10 percent of the voting stock, he is considered to own stock owned by corporations in an affiliated group of corporations as well as the stock owned directly.

The bill also defines as direct investments exempt from tax the acquisition of an interest in, or a debt obligation of, a foreign partnership by a general partner if such partner is entitled to a 10-percent or

greater interest in the profits of the partnership immediately following the acquisition.

In general, the 10-percent ownership requirement exempts all transactions which would normally be considered business investments. However, your committee's attention was directed to the fact that in certain foreign countries U.S. persons are prevented by government regulation from acquiring as much as a 10-percent interest in certain corporations even though the business of the foreign corporation is directly related to the business of the U.S. person. In such cases (and in similar cases involving general partnership interests) the bill provides for exemption from the tax even though the U.S. person owns less than 10 percent of the voting stock of the foreign corporation (or less than a 10-percent interest in the profits of a partnership).

The "direct investment" exception is not to apply if the foreign corporation or partnership is formed or availed of for the principal purpose of acquiring stock or debt obligations of foreign issuers or obligors in a case where the 10-percent owner would be subject to tax upon acquisition had the stock or debt obligations been acquired directly by him. Thus, U.S. persons will not be allowed to form "closely held" holding companies for the purpose of acquiring securities which would be taxed if acquired directly. Moreover, if a U.S. person acquires stock or debt obligations of a foreign corporation in which he owns a 10-percent or greater stock interest, for the purpose of selling, or offering for sale, any part of the stock or debt obligations to U.S. persons, the exemption will not apply.

4. *Commercial bank loans.* The bill provides an exclusion from tax for the acquisition of debt obligations by a commercial bank in the making of loans in the ordinary course of its commercial banking business. In part, this is attributable to the fact that the great bulk of commercial bank loans fall within the less than 3-year maturity range and therefore would in any event not be subject to tax. However, this exclusion also recognizes the special role played by banks in support of normal, recurring financing of the international business of American firms. Also, it permits the banks to continue freely their role in financing U.S. exports and their conduct of banking operations in foreign countries through branches. In this latter case, their activities normally consist of receiving deposits in foreign currencies and making loans in such currencies. These transactions, of course, have no effect on the U.S. balance-of-payments position.

Your committee is aware that a generalized exclusion of this type could be abused. Although that is not expected, your committee does consider it necessary to provide specific authority in the bill for the collection of detailed and timely information on the nature of, and trends in, bank lending to foreign persons. The information collected under these reporting requirements will provide a basis both for determining whether a general exclusion of this character should be continued and, if not, for indicating the specific ways in which the general exclusion should then be modified.

The possible need for and practicability of amending this legislation with respect to loans of commercial banks will be reviewed by your committee should this evidence suggest that bank lending to industrialized countries abroad, whose borrowing will otherwise be subject to tax, is rising in amounts out of proportion to a general expansion in the banking business or amounts related to the normal recurring

needs of international trade. A sizable increase in bank lending that appeared to be related to a diversion of credit demands from channels subject to the tax would be a source of particular concern to your committee.

5. *Export financing.*—One of the best ways of reducing the deficit in the U.S. balance of payments is to increase exports from this country. American business has had an excellent record in this regard and to maintain and improve this record it is essential that American firms have the ability to offer credit facilities to their foreign customers, whether for short- or long-term loans. Therefore, your committee has provided for a series of exemptions for stock and debt obligations of foreign issuers or obligors which are acquired as a result of export transactions. These are listed below:

A. *Guarantees by Export-Import Bank.*—The bill provides that the acquisition of debt obligations which are guaranteed or insured in whole or in part by the Export-Import Bank (or other U.S. Government agencies or instrumentalities) are to be exempt from tax. This exemption is based on the fact that the Export-Import Bank guarantees or insures a loan only if, and to the extent, the debt obligation received by the U.S. exporter is attributable to the sale of goods produced in the United States. This exemption applies without regard to the relationship of the exporter to the producer of the goods.

B. *Goods produced in United States.*—If a U.S. person acquires a debt obligation in the course of his trade or business as a result of the sale of property manufactured, produced, grown, or extracted in the United States, the bill provides that the acquisition of the debt obligation is to be exempt from tax if 85 percent or more of the purchase price in the transaction is attributable to the sale of such property, and to the performance of services, by the U.S. person. However, the initial acquisition will in most cases, in effect becomes subject to tax if the U.S. producer transfers the debt obligation to a U.S. person other than a commercial bank which acquires it in the ordinary course of its commercial banking business or other than to an agency or instrumentality of the United States. This restriction on transferability is designed to prevent avoidance of tax by introduction of the exporter into a market transaction normally financed by unrelated financial institutions.

C. *U.S. contractors and suppliers.*—The bill provides that tax is not to apply to the acquisition of stock or debt obligations if 30 percent or more of the purchase price is attributable to the sale of property manufactured, produced, grown, or extracted in the United States by, and services performed by, the person who acquires the stock or debt obligation. However, this is to be true only if 50 percent or more of the purchase price is attributable to the sale of property manufactured, produced, grown, or extracted in the United States, and services performed, by all U.S. persons. This is designed to provide for a problem called to your committee's attention in its public hearings on H.R. 8000. It was pointed out that U.S. persons often bid on an entire foreign project and, as a condition to obtaining the business, are required to take part of the contract price in the form of stock or debt obligations of a foreign issuer or obligor. In many of these contracts, a portion, but not all, of the contract price is attributable to the sale of U.S.-produced goods. In the contracts referred to, the foreign stock or debt obligations are required to be

taken by the principal contractor, even though some of the U.S.-produced goods which are furnished in connection with the project may be supplied by U.S. subcontractors. Your committee believes that imposition of tax on acquisitions of this type might impede U.S. contractors and suppliers when competing for foreign projects. As in the case of debt obligations acquired in simple export transactions, tax would generally apply at the time of transfer (based upon the initial acquisition price) if the debt obligation is later transferred to a U.S. person other than a commerical bank which acquires it in the ordinary course of its commercial banking business or other than to an agency or instrumentality of the United States. Similarly, the tax will in effect apply to the initial acquisition of stock if the stock is transferred to any U.S. person before January 1, 1966.

D. *Export-related loans.*—The bill provides that the acquisition of a debt obligation is to be exempt from tax if the U.S. person making the loan and receiving the debt obligation can show that the proceeds of the loan will be used for the storage, handling, transportation, processing, packaging, or servicing of property produced by him in the United States. This is designed to cover cases where U.S. producers, in an effort to distribute their products abroad, are required to finance the construction of foreign fabricating, distribution, and marketing facilities which are necessary if U.S. exports of supplier products are to be increased or maintained. Since the exporter-producer generally would not transfer the debt obligation acquired in a transaction of this kind, the bill provides that tax will, in most cases, attach at the time of the transfer (based upon the initial acquisition price) if the U.S. person transfers the debt obligation to a U.S. person other than a commercial bank which acquires it in the ordinary course of its commercial banking business or other than to an agency or instrumentality of the United States. As in the case of debt obligations acquired by an exporter in payment for exported goods, and in the case of contractors financing entire foreigh projects, tax is not payable if the debt obligation is transferred to a foreign person, since the acquisition and transfer of a debt obligation under such circumstances does not have an adverse effect on the balance of payments.

6. *Other exemptions provided.*—Your committee's bill also provides a series of additional exemptions, described below, designed to deal with specific types of situations. Some of these relate to businesses which, because of their nature deal in foreign securities. Others are related to natural resource or raw material sources outside of the United States. The other exemptions are for various other factors. In general, these exemptions have one factor in common, however: the acquisition of the foreign securities is due to factors other than the interest rate differential between American and foreign security markets. The exemptions are as follows:

A. *Insurance companies with foreign business.*—In general, the bill permits insurance companies to elect to acquire stock and debt obligations of foreign issuers and obligors tax free in an amount equal to 110 percent of their reserves against foreign risks. If such an election is made, the company must designate stock of foreign issuers, and debt obligations of foreign obligors having a period remaining to maturity of 3 years or more, which it owned on December 10, 1963, as part of such fund. It also is to designate stock and debt obliga-

tions acquired after December 10, 1963, which it wants to consider as part of the fund. Once a foreign security is designated as part of one of these exempt reserve funds, if the insurance company sells the security to a U.S. person, the U.S. purchaser will pay tax on the security as if he acquired it from a foreign person. Of course, if it sells the security to a foreign person, no tax would have to be paid by it or the foreign purchaser. In addition to this exemption, insurance companies, like other U.S. persons, may acquire securities tax free under other sections of the bill. The reason for this exemption can be explained as follows: Domestic insurance companies often engage in business in foreign countries through branch operations. In the conduct of this business, they collect premiums in a foreign currency, reinvest the premiums in stock and debt obligations payable in that foreign currency, and must pay liabilities arising under the insurance contract in the same currency as that in which the premiums are collected. These transactions do not, of course, affect the balance-of-payments accounts of the United States. Moreover, an imposition of a tax on such transactions would impose an unreasonable burden on such companies by requiring them, in order to avoid the tax, to invest their reserves in U.S. securities and thereby expose themselves to a foreign exchange risk between the time of investment of premiums and the time claims under the policy were payable.

B. *Underwriters and dealers.*—In the case of underwriters and dealers of foreign securities, the bill provides a procedure which in effect permits them to purchase these securities from foreign issuers and obligors and sell them to other foreign persons without tax effect. Under the provision in the bill, the underwriter is subject to tax when he buys a security from a foreign person without regard to the person to whom he intends to sell it. However, if he or a member of the same distributing group sells it to a foreign person, he may claim a credit or refund for the tax previously paid. In addition, a dealer in foreign bonds is exempted from tax on acquisitions made in the ordinary course of his business if the bonds are resold to foreign persons within a specified period. A refund of tax is provided for the dealer or underwriter in such cases since these transactions do not adversely affect the balance-of-payments position of the United States and assist in maintaining effective international capital market facilities.

C. *Labor unions, etc.*—The bill provides an exemption from tax for a tax-exempt organization (described in sec. 501(c)) operating in a foreign country through a local organization to the extent the acquisitions result from the investment of contributions or membership fees paid in the currency of the foreign country by individuals who are members of the local organization if the securities acquired are held exclusively for the benefit of the local organization. Representatives of labor organizations which appeared before your committee stated that their unions collect dues in foreign currency from their members who are residents in the foreign country. The unions invest these dues in stock or debt obligations arising in the foreign country. Subsequently, they dispose of these securities as necessary to meet their foreign obligations. Your committee believes that transactions of this type, like the insurance company reserve provisions described above, should be exempt from tax since they do not affect the U.S. balance of payments and would unnecessarily expose them to an exchange risk. Moreover, investments of this type are not made in response to interest rate differentials.

D. *Ores and minerals with inadequate U.S. supply.*—The bill contains an exemption for loans by U.S. persons to a foreign corporation if 50 percent or more of the total combined voting power of all classes of stock of the foreign corporation is owned by U.S. persons and the foreign corporation extracts or processes ores or minerals. This exemption is only available, however, if the available deposits in the United States of the ore or, mineral, involved are inadequate to satisfy the needs of domestic producers. In addition, a U.S. person owning the voting stock of the corporation must agree to pay an amount sufficient to amortize a portion of the loan under a so-called "take-or-pay" contract by which it agrees either to purchase a part of the production of the foreign corporation or to pay a portion of its costs of operation. Usually, a U.S. corporation's commitment to finance a foreign supplier of this type is satisfied through a direct loan from the U.S. shareholder. Such a loan would be exempt under the "direct investment" exemption. This exemption, therefore, will be of limited application but is desirable as a way of providing shareholders flexibility in the manner in which they finance the acquisition of foreign ores and minerals such as bauxite, which cannot be acquired in sufficient quantities in the United States.

E. *Ores and minerals extracted and sold outside the United States.*—The bill provides an exemption for debt obligations acquired by a U.S. person as a result of the sale by him of ores or minerals (or derivatives of the ores or minerals) extracted outside the United States if the foreign purchaser agrees to purchase such ores or minerals for a period of 3 years or more. Provision is also made in the bill to permit these companies to acquire debt obligations of foreign obligors tax free if the proceeds of the loan are to be used by the borrower to install, maintain, or improve facilities for the storage, handling, transportation, processing, or servicing of ores or minerals extracted outside the United States. Acquisitions of debt obligations made as the result of the sale of domestic ores and minerals, or the financing of facilities for their distribution will, of course, be exempt under the general provision relating to export loans. Since, however, the ores and minerals available to U.S. companies may be located in other parts of the world, this provision extends the exclusion to transactions involving foreign ores and minerals. If a U.S. person acquires a debt obligation tax free under this provision and transfers it (before January 1, 1966) to a U.S. person, other than a commercial bank receiving it in the normal course of its commercial banking business, or to an agency or instrumentality of the United States, he will in most cases be subject to tax in the same manner as if the original acquisition were taxable.

F. *Acquisition required by foreign law.*—The bill provides an exemption from tax in the case of securities acquired by a U.S. person doing business in a foreign country to the extent these acquisitions are reasonably necessary to satisfy minimum requirements relating to the holding of foreign securities imposed by the laws of the foreign country. Insurance companies, with respect to their insurance reserves, in effect are allowed to apply this exemption or the special tax exemption with respect to foreign reserves, whichever results in the greater holdings of foreign securities. This exemption is provided because some foreign countries require foreign businesses engaged in business locally to investment a portion of their assets in securities of that country as a condition to doing business there. Usually restric-

tions of this type exist in the case of less developed countries with shortages of local investment funds and with serious exchange problems. However, most foreign countries impose restrictions of this type on regulated industries such as commercial banks, insurance companies, etc. Since these acquisitions of foreign securities arise from business necessity and are not influenced by interest rate differentials, the bill provides an exemption in these cases. If a U.S. person claims an exemption with respect to foreign securities under this provision and then subsequently disposes of these securities, he is treated as a foreign person with respect to this transfer. Thus if he transfers the securities to a U.S. person, this person will generally be subject to tax on this acquisition.

G. *Foreign corporations controlled by Americans and traded here.*—The bill treats as a domestic corporation for purposes of this tax certain foreign corporations other than investment companies. The effect of this is to exempt purchases of their stock from the interest equalization tax. The foreign corporations qualifying for this treatment are those whose stock is traded on a national securities exchange or exchanges registered with the Securities and Exchange Commission if the trading on these U.S. exchanges represented the principal market for their stock during 1962 and if more than 50 percent of the stock was held by U.S. persons (on the latest record date before July 19, 1963).

c. Administrative provisions

1. *Certification procedure.*—As indicated previously, the interest equalization tax does not apply where foreign securities are purchased from a U.S. person. To distinguish taxable from nontaxable transactions, the bill provides for the use of a certification procedure. Under this procedure, receipt of a certificate of American ownership in connection with the acquisition of a foreign security is considered as conclusive proof of prior American ownership unless the person receiving it has actual knowledge that the certificate is false.

A substitute procedure is available in the case of securities purchased on a registered national securities exchange, if the exchange has adopted rules under which transactions will be permitted in the "regular market" only where the seller is a U.S. person. Other transactions through these exchanges would be treated as "special contracts." If a broker provides the purchaser with a written confirmation that the security obtained for him was acquired in the "regular market," this will be considered the equivalent of receiving a certificate of American ownership by the purchaser. The broker will also provide written confirmation in the case of "special contracts" which will indicate that the security was not purchased in the regular market and, therefore, may be subject to tax. A U.S. person selling on such an exchange may file individual certificates of American ownership with his broker with respect to each transaction. Alternatively, he may file a blanket certificate of American ownership with the broker which will qualify all his subsequent sales through the same account. Essentially the same treatment is available in the case of over-the-counter trading which is subject to similar rules promulgated by the National Association of Securities Dealers.

The bill provides a penalty equal to 125 percent of the applicable tax in the case of a person who willfully executes a certificate of American ownership or a blanket certificate of American ownership

which is false in any material respect. The penalty also applies in the case of false reports of sales to foreign persons. The penalty is an assessable one, which means that it may be collected in the same manner as the tax. This is provided to discourage persons from executing false certificates. Similar penalties are provided in case false confirmations are furnished by members of either registered national securities exchanges or the National Association of Securities Dealers. Unless the person acquiring the stock or debt obligation had actual knowledge that the certificate involved is false in any material respect, the penalty applicable in the case of false certification is in lieu of, rather than in addition to, any interest equalization tax.

The bill also provides criminal penalties for the willful execution of individual and blanket certificates of American ownership or sales to foreign persons which are false in any material respect. The criminal penalty in this case makes the willful execution of a false certificate a misdemeanor and provides for a fine of not more than $1,000, or imprisonment for not more than 1 year, or both.

2. *Filing returns.*—Tax liability in the case of the interest equalization tax is to be reported by the filing on a calendar quarter basis of returns covering all of the taxable and certain other transactions occurring within the calendar quarter. The returns must be filed on or before the last day of the first month following the period for which the return is made. (However, the first return period commences July 19, 1963, and ends at the close of the calendar quarter in which this bill is enacted.)

Returns must be filed and reporting must be made on the return both with respect to taxable transactions and also nontaxable transactions where exemption certificates were received. However, in the case of nontaxable transactions, where the purchaser has received written confirmation from members of a registered national securities exchange or the National Association of Security Dealers, the transactions need not be reported on these quarterly returns. If required returns are not filed, a civil penalty of 5 percent of the amount of the tax is provided, except that the penalty in no event may be less than $10 or more than $1,000. The penalty does not apply where the failure to file can be shown to be due to reasonable cause.

3. *Nondeductibility of tax.*—The bill provides that for income tax purposes, deductions may not as a general rule be taken for the interest equalization tax by persons acquiring foreign securities. However, this amount may be capitalized by the person and, therefore, treated as an amount paid by him for the security. If the interest equalization tax paid by the U.S. person when added to the cost of a debt obligation creates bond premium, this premium will be amortizable, and deductible, in the same manner as other bond premium under existing law; namerly, rateably over the life of the bond. If the foreign seller of the bond reimburses the U.S. person who buys the bond for part or all of the tax paid by him, this amount is treated as an item of income to the purchaser at that time. However, in such cases he also receives a deduction for the tax in a like amount and to that extent does not add the tax to his basis for the bond.

d. Effective Date

The bill generally is effective with respect to acquisitions by U.S. persons of foreign securities made on or after July 19, 1963. This is 1 day after the date Congress received the President's special message to the Congress on the balance of payments and the public announcement of the principal features proposed by the administration for this bill. However, a special effective date is provided for acquisitions of foreign securities acquired on a national securities exchange registered with the Securities and Exchange Commission. For these acquisitions the effective date is August 17, 1963. This later effective date permitted uninterrupted trading in foreign securities on the exchanges, while they were adjusting their trading rules and procedures to the requirements of the proposed bill.

Your committee recognized, however, that the application of the tax to acquisitions resulting from transactions which were in advanced stages of negotiation on July 18, 1963, would have created serious hardships. For that reason, the bill provides that acquisitions made after July 18, 1963, are exempt from tax in various situations such as the four following types of situations:

(1) The acquisition was made pursuant to an obligation which was unconditional on July 18, 1963 (or was subject only to conditions contained in a formal contract under which partial performance had occurred);

(2) The acquisition was made by a person who had taken every action, on or before July 18, 1963, necessary to signify approval of the acquisition under the procedures ordinarily employed by him in similar transactions and had sent the foreign issuer or obligor a commitment letter in which he set forth the principal terms of the acquisition;

(3) The acquisition was made by a U.S. person (exempt under sec. 4915 except for subsec. (c)) who had applied for, and received from a foreign government, on or before July 18, 1963, authorization to make the acquisition, if this authorization was required in order for it to be made; and

(4) If the acquisition was made before September 17, 1963, of stock or a debt obligation covered by a registration statement filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days prior, and the registration statement had not been amended after July 18, 1963, and before the acquisition, in a manner to increase the number of shares of stock or the aggregate face amount of the debt obligations covered by the registration statement.

The bill also provides that tax is not applicable to the acquisition of foreign stock made pursuant to the exercise of an option or similar right held on July 18, 1963, by the acquiring person (or by a decedent from whom he acquired the option or right). U.S. persons who held employees' stock options on July 18, 1963, may exercise their options without tax, and persons who held convertible debentures on July 18, 1963, may convert their debentures to stock without tax.

e. Revenue effect

It is estimated that this bill will result in an annual revenue gain of up to $30 million in a full year of operation.

IV. TECHNICAL EXPLANATION OF THE BILL

SECTION 1. SHORT TITLE, ETC.

(*a*) *Short title.*—Subsection (a) of section 1 of the bill provides that the bill may be cited as the "Interest Equalization Tax Act of 1963."

(*b*) *Amendment of 1954 code.*—Subsection (b) of section 1 of the bill provides that whenever in the bill an amendment is expressed in terms of an amendment to a section or other provision, the reference is considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SECTION 2. INTEREST EQUALIZATION TAX

(*a*) *Imposition of tax.*—Subsection (a) of section 2 of the bill adds to subtitle D of the code (relating to miscellaneous excise taxes) a new chapter 41, imposing an interest equalization tax and consisting of sections 4911 through 4920.

SECTION 4911. IMPOSITION OF TAX

(*a*) *In general.*—Section 4911(a) imposes a tax on each acquisition by a U.S. person of stock of a foreign issuer, or of a debt obligation of a foreign obligor if such obligation has a period remaining to maturity of 3 years or more. The amount of tax imposed on each such acquisition is determined under section 4911(b). The term "acquisition" is defined in section 4912(a); the terms "United States person," "stock," "foreign issuer," "debt obligation," "foreign obligor," and "period remaining to maturity" are defined in section 4920.

(*b*) *Amount of tax.*—Paragraph (1) of section 4911(b) provides that the tax imposed on the acquisition of stock of a foreign issuer is equal to 15 percent of the actual value of the stock.

Paragraph (2) of section 4911(b) provides that the tax imposed on the acquisition of a debt obligation of a foreign obligor is equal to a percentage of the actual value of the debt obligation measured by the period remaining to its maturity, determined in accordance with the following table:

If the period remaining to maturity is—	The tax, as a percentage of actual value, is—
At least 3 years, but less than 3½ years	2.75
At least 3½ years, but less than 4½ years	3.55
At least 4½ years, but less than 5½ years	4.35
At least 5½ years, but less than 6½ years	5.10
At least 6½ years, but less than 7½ years	5.80
At least 7½ years, but less than 8½ years	6.50
At least 8½ years, but less than 9½ years	7.10
At least 9½ years, but less than 10½ years	7.70
At least 10½ years, but less than 11½ years	8.30
At least 11½ years, but less than 13½ years	9.10
At least 13½ years, but less than 16½ years	10.30
At least 16½ years, but less than 18½ years	11.35
At least 18½ years, but less than 21½ years	12.25
At least 21½ years, but less than 23½ years	13.05
At least 23½ years, but less than 26½ years	13.75
At least 26½ years, but less than 28½ years	14.35
28½ years or more	15.00

In general, actual value is determined by the consideration paid by a purchaser in an arm's length transaction. In no event will the actual value of any stock or debt obligation acquired be considered to be less than the actual value of the money or other property paid for such stock or debt obligation.

(c) *Persons liable for tax.*—Section 4911(c) provides (in par. (1)) that the tax imposed by section 4911(a) is to be paid by the person acquiring the stock or debt obligation involved. In general, the person who (immediately prior to a transaction constituting an acquisition under ch. 41) owns the money or other property transferred as the consideration for the stock or debt obligation acquired is considered the person who makes the acquisition and is liable for the tax. The fact that some other person is the registered owner of the stock or obligee of the debt obligation does not make such person liable for the tax, or relieve the transferor of the property of liability, if such other person is not in fact the owner. A nominee, custodian, or agent who purchases stock or a debt obligation on behalf of his principal is not considered as having made an acquisition of such stock or debt obligation; the person for whom the stock or debt obligation has been purchased is treated as having made the acquisition. For example, a broker who purchases stock of a foreign issuer in his capacity as broker is not considered as having obtained ownership of such stock even if it is registered in the broker's name pursuant to the instructions of the person for whom the broker is acting; the person for whom the broker is acting is treated as having made the acquisition of the stock.

Section 4911(c) also contains (in par. (2)) a cross reference to section 6681 of the code (added by sec. 5(a) of the bill), which provides for the imposition of a penalty on the maker of a false interest equalization tax certificate. Such penalty may be in lieu of or in addition to the tax.

(d) *Termination of tax.*—Section 4911(d) provides that the tax imposed by section 4911(a) will not apply to any acquisition made after December 31, 1965.

SECTION 4912. ACQUISITIONS

(a) *In general.*—Section 4912(a) defines the term "acquisition" as any purchase, transfer, distribution, exchange, or other transaction (whether occurring within or outside the United States) by virtue of which ownership is obtained either directly or through a nominee, custodian, or agent.

As a general rule, an acquisition is considered as having been made on the date the consideration is paid for the stock or debt obligation acquired. Where a U.S. person enters into an agreement to make a series of loans to a foreign person over a period of time, each particular loan is treated as a separate acquisition of a debt obligation of a foreign obligor, occurring as of the date the loan is made. In the case of an acquisition of stock subject to the rules of a national securities exchange or national securities association registered with the Securities and Exchange Commission, the acquisition will normally be deemed to occur on the settlement date provided in such rules (whether or not payment is actually made on that date), although the actual value of the stock will normally be fixed as of the

trade date by reference to the price at which the purchase was effected. The application of these rules is illustrated by the following examples:

Example (1).—On December 27, 1963, A, a U.S. person, places an order with his broker to purchase, pursuant to a special contract, 100 shares of the stock of foreign corporation M from a nonresident alien; the stock is traded on the New York Stock Exchange. The order is executed on that date at a price of $10 per share. A gives his check for $1,000 to his broker on December 31, 1963. Pursuant to the rules of the exchange, settlement is not due to be made until 4 business days after the trade date. Because of an intervening Saturday and Sunday (December 28 and 29, 1963) and holiday (January 1, 1964), the settlement date with respect to A's acquisition falls on January 3, 1964. A is considered to acquire the M stock on January 3, 1964. The actual value of the M stock is $1,000, and A is liable to pay a tax of $150 with his return covering the first calendar quarter of 1964.

Example (2).—B, a U.S. person, enters into an agreement to make a series of loans to foreign corporation N. Pursuant to the terms of the agreement, B transfers $10,000 to N on January 1, 1964, $10,000 on March 30, 1964, and $10,000 on June 1, 1965. All of the loans mature on September 10, 1968. B acquires on January 1, 1964, a debt obligation of a foreign obligor having a period remaining to maturity of between 4½ and 5½ years. B acquires on March 30, 1964, a debt obligation of a foreign obligor having a period remaining to maturity of between 3½ and 4½ years. B acquires on June 1, 1965, a debt obligation of a foreign obligor having a period remaining to maturity of between 3 and 3½ years.

Section 4912(a) also provides that a U.S. person acting as a fiscal agent in connection with the redemption or purchase for retirement of stock or debt obligations is not considered to obtain ownership of such stock or debt obligations, even though such person acts in a capacity which technically may be that of a trustee. The person on whose behalf the fiscal agent is acting is considered as having made the acquisitions involved.

In addition, section 4912(a) provides that the exercise of a right to convert a debt obligation (as defined in sec. 4920(a)(1)) into stock is deemed an acquisition of stock from the foreign issuer by the person exercising such right. Thus, if a U.S. person acquires such a debt obligation (whether or not from the foreign obligor) and then exercises the right to convert, the stock so acquired is considered as having been acquired from the foreign issuer of the stock at the time of exercise. (Sec. 4913(a)(3)(A) contains a special limitation on the amount of tax that is imposed in certain cases when stock is acquired pursuant to the exercise of the right to convert a debt obligation into stock; and sec. 2(c)(6) of the bill contains a provision excluding from the tax the exercise of certain rights to convert debt obligations which were held on July 18, 1963.)

Finally, section 4912(a) provides that any extension or renewal of an existing debt obligation requiring affirmative action of the obligee is considered the acquisition of a new debt obligation. (Sec. 4913(a)(2) provides a limitation on the tax imposed on an acquisition of this kind; and sec. 4920(a)(7)(B)(ii) provides a rule for the treatment of the acquisition of a debt obligation which is renewable without affirmative action by the obligee.)

(*b*) *Special rules.*—Section 4912(b) contains special rules under which certain types of transactions are deemed to constitute acquisitions for purposes of the new chapter 41.

Certain transfers to foreign trusts

Paragraph (1) of section 4912(b) provides that any transfer (other than in a sale or exchange for full and adequate consideration) of money or other property to a foreign trust is deemed an acquisition by the transferor of stock of a foreign issuer in an amount equal to the actual value of the money or property transferred, but only to the extent that such trust acquires stock or debt obligations which would, if acquired directly by the transferor, be subject to the interest equalization tax. If any stock or debt obligation acquired by the foreign trust would not have been taxable had the acquisition been made directly by the transferor, then such stock or debt obligation is not taken into account under this paragraph. This rule is applicable without regard to whether the transferor is a beneficiary of, or otherwise interested in, the trust. As a general rule, the owner of property immediately before its transfer is considered the "transferor" for these purposes. (Sec. 4913(b) provides a limitation on the tax in the case of a transfer, deemed to be an acquisition under this paragraph, which is otherwise taxable under ch. 41.)

The special rule contained in section 4912(b)(1) does not apply to transfers made to a foreign trust in a sale or exchange for full and adequate consideration. If, however, the consideration received by the U.S. person consists of stock of a foreign issuer or debt obligations of a foreign obligor with a period remaining to maturity of 3 years or more, the acquisition of such stock or debt obligations is taxable to the extent otherwise provided in chapter 41. Transfers by a U.S. person to a foreign trust of which he is a beneficiary are not considered, simply by reason of his beneficial interest, to be for full and adequate consideration. The exception to the special rule relating to a sale or exchange for full and adequate consideration does not cover loans; loans are not considered sales or exchanges for this purpose.

One additional exception is provided to the coverage of the special rule contained in section 4912(b)(1). Contributions to a foreign pension or profit-sharing trust established by an employer, made by an employee who performs personal services on a full-time basis in a foreign country (and is not an owner-employee as defined in sec. 401(c)(3) of the code) are not deemed acquisitions of stock of a foreign issuer. Thus, such an employee can contribute money to a foreign pension or profit-sharing trust established by his employer, and his contributions will not be deemed acquisitions of stock of a foreign issuer even if the trust acquires foreign stock or debt obligations which would be subject to the tax had the employee acquired them directly. The exception is not applicable to contributions by an employer.

The application of section 4912(b)(1) is illustrated by the following examples:

Example (*1*).—On July 25, 1964, A, a U.S. person, transfers $1,000 to X, a foreign trust, and X acquires voting stock of Y, a foreign corporation, for $800, on September 3, 1964. The direct acquisition by A of the Y stock would have been taxable to him. A is considered to have acquired stock of a foreign issuer on July 25, 1964, in the amount of $800 and incurs a tax of $120 (15 percent of $800).

Example (2).—The facts are the same as in example (1). A makes no further transfers to foreign trust X but on December 1, 1964, X acquires from B, a nonresident alien individual, debt obligations of Z, a foreign corporation, with a period remaining to maturity of 10 years. The direct acquisition by A of the Z debt obligations would have been taxable to him. The purchase price of these debt obligations is $300. A is considered to have acquired (as of July 25, 1964) stock of a foreign issuer—not a debt obligation of a foreign obligor—in an additional amount of $200, representing the balance of the $1,000 transferred to X which remains after the application of $800 to the earlier acquisition. A therefore incurs an additional tax of $30 (15 percent of $200).

Example (3).—The facts are the same as in example (2), except that B is a U.S. person. A incurs no additional tax by reason of the purchase by the trust of the Z debt obligations. The same result would follow if B were a nonresident alien individual but Z were a less-developed country corporation.

Certain transfers to foreign corporations and partnerships

Paragraph (2) of section 4912(b) provides that any transfer of money or other property to a foreign corporation or foreign partnership, either (A) as a contribution to the capital of such corporation or partnership, or (B) in exchange for one or more debt obligations of such corporation or partnership if it is a foreign corporation or partnership formed or availed of by the transferor to acquire (through such corporation or partnership) stock or debt obligations the direct acquisition of which by the transferor would be subject to the tax imposed by section 4911, is deemed an acquisition by such transferor of stock of such foreign corporation or partnership in an amount equal to the actual value of the money or property transferred. Amounts paid to satisfy stock assessments are considered to be contributions to capital.

The application of section 4912(b)(2) is illustrated by the following examples:

Example (1).—A, a U.S. person, transfers $1,000 to foreign corporation M as a contribution to its capital. A is considered to have acquired stock of M in the amount of $1,000 and the acquisition (if not otherwise excluded under ch. 41) is subject to tax in the amount of $150.

Example (2).—A, a U.S. person, owns 10 percent of the voting stock of foreign corporation M, all of which he acquired before July 18, 1963. On April 9, 1964, A transfers $5,000 to M in exchange for a 2-year promissory note of M. On June 1, 1965, M is availed of by A for the principal purpose of acquiring, for $3,500, stock of foreign corporation N. Because of section 4915(c)(1) the exclusion for direct investments cannot apply to A's acquisition of M's promissory note; and because A's acquisition is deemed to be an acquisition of stock the exemption for debt obligations of less than 3 years' maturity does not apply. Accordingly, the acquisition (if not otherwise excluded under ch. 41) is subject to tax in the amount of $750 (15 percent of $5,000).

Acquisitions from domestic corporation or partnership formed or availed of to obtain funds for foreign issuer or obligor

Paragraph (3) of section 4912(b) provides that the acquisition of stock or a debt obligation of a domestic corporation (other than a domestic corporation described in sec. 4920(a)(3)(B)), or a domestic partnership, formed or availed of for the principal purpose of obtaining funds, whether directly or indirectly, for a foreign issuer or obligor, is deemed an acquisition from such foreign issuer or obligor of its stock or debt obligation. The effect of this provision is to treat the stock or debt obligation of such a domestic corporation or partnership as that of a foreign issuer or obligor and, therefore, subject to the interest equalization tax unless it is otherwise excluded (as, for example, under sec. 4915, 4916, or 4917) because of the status of (or the relationship of the acquiring person to) the foreign issuer or obligor; the status of (or relationship to) the domestic corporation or partnership will not serve to provide (or prevent) such an exclusion. On the other hand, this rule is not applicable to a domestic corporation or partnership which obtains capital to be used by it in the active conduct of its own business, or the active conduct of a business by it as a participant in a joint venture, even though the corporation or partnership may be wholly owned by a foreign issuer or obligor. The acquisition and holding of investments is not the active conduct of a trade or business for this purpose.

Reorganization exchanges

Paragraph (4) of section 4912(b) provides that an acquisition of stock or debt obligations of a foreign issuer or obligor by a U.S. person in an exchange to which section 354, 355, or 356 of the code applies (or would apply but for sec. 367) is considered an acquisition from the foreign issuer or obligor in exchange for its stock or debt obligations. Under this rule, stock distributed in a reorganization is deemed to have been acquired from the foreign issuer even though actually received from another corporation which is a party to the reorganization. As a result, a U.S. person receiving stock of the foreign issuer in such an exchange for stock of another corporation will qualify for the exclusion provided by section 4914(a)(4). The rule also treats any stock or debt obligations surrendered in the exchange as stock or debt obligations of the foreign issuer or obligor. As a result, a U.S. person acquiring debt obligations of the foreign obligor in such an exchange for stock or debt obligations of another corporation will be entitled to apply the limitation on tax provided by section 4913(a)(2). Although this special rule does not apply to a domestic corporation acquiring stock or debt obligations of a foreign issuer or obligor as a party to a reorganization, such an acquisition may be excluded by some other provision of chapter 41 (as, for example, sec. 4914(a)(5) or 4915(a)).

The application of section 4912(b)(4) is illustrated by the following examples:

Example (1).—A, a U.S. person, owns stock of X, a domestic corporation. On July 30, 1964, X transfers a portion of its assets to Y, a foreign corporation, in exchange for 80 percent of the voting stock of Y. X then distributes the stock of Y to its shareholders in exchange for X stock. The transaction is one to which section 355 of the code would apply, although no prior ruling under section 367 is obtained.

A is considered (for purposes of ch. 41) to have acquired Y stock in a distribution by Y in exchange for its stock.

Example (2).—B, a U.S. person, owns stock of M, a foreign corporation. On July 30, 1964, B surrenders his M stock to N, another foreign corporation, in exchange for voting stock of N. The transaction is one to which section 354 of the code would apply. B is considered (for purposes of ch. 41) to have acquired the N stock in a distribution by N in exchange for its stock.

SECTION 4913. LIMITATION ON TAX ON CERTAIN ACQUISITIONS

(*a*) *Certain surrenders, extensions, renewals, and exercises*.—Section 4913(a) provides limitations on the amount of the interest equalization tax otherwise applicable in the case of certain specified types of acquisitions.

General rule

Paragraph (1) of section 4913(a) provides that the limitations set forth in such section are applicable to acquisitions of stock or debt obligations of foreign issuers or obligors in cases where the acquisition involved results from—

(A) the surrender to the foreign obligor, for cancellation, of a debt obligation of such obligor;

(B) the extension or renewal of an existing debt obligation requiring affirmative action of the obligee; or

(C) the exercise of an option or similar right to acquire such stock or debt obligation (or a right to convert a debt obligation into stock).

By reason of the rule set forth in section 4912(b)(4), transactions described in subparagraph (A) of this paragraph include certain transactions in which stock or debt obligations of the foreign issuer or obligor are received upon surrender of a debt obligation of another corporation which is a party to a reorganization.

General limitation

Paragraph (2) of section 4913(a) provides that the tax imposed upon any acquisition referred to in paragraph (1) of such section, except in cases to which paragraph (3) applies, will not exceed the amount of tax imposed by section 4911 less the amount of tax that would have been imposed if the debt obligation (or the option or right) which was surrendered, extended, renewed, or exercised had been acquired in a transaction subject to such tax immediately prior to the surrender, extension, renewal, or exercise. For this purpose, a defaulted debt obligation of a foreign government or subdivision (or an agency or instrumentality thereof) which has been in default as to payment of principal for at least 10 years and which is surrendered in exchange for another debt obligation of that government or subdivision (or agency or instrumentality) is deemed to have an actual value and period remaining to maturity equal to that of the debt obligation acquired. For purposes of paragraph (2), the term "option or right" does not include the right to convert a debt obligation (as defined in sec. 4920(a)(1)) into stock; the limitation on tax upon the exercise of such a conversion privilege is separately treated in paragraph (3). (The exercise of certain rights of shareholders and employees to acquire stock is also subject to the special rules in par. (3).)

The application of section 4913(a)(2) is illustrated by the following examples (in which none of the exclusions or exemptions provided by ch. 41 is applicable):

Example (1).—A is a U.S. person, and M corporation is a foreign corporation. A surrenders a debt obligation of M, having at the time a period remaining to maturity of 5½ years and an actual value of $900, in exchange for a debt obligation of M having a period remaining to maturity of 10½ years and an actual value of $950. A incurs a tax of $32.95, representing the amount of tax imposed on the actual value of the debt obligation acquired (8.3 percent of $950, or $78.85) less the amount of tax that would have been imposed if the debt obligation which was surrendered had been acquired in a transaction subject to tax immediately prior to its surrender (5.1 percent of $900, or $45.90).

Example (2).—B is a U.S. person, and N is a foreign corporation. B acquires a debt obligation of N which will mature in 30 days, and the instrument provides that the obligation will become payable at maturity unless within the 30-day period prior to maturity the parties agree to extend the obligation on the same terms for an additional 5-year period. The parties so agree. The actual value of the debt obligation before and after the extension is $1,000. B incurs a tax of $43.50, representing the amount of tax imposed on the actual value of the debt obligation acquired (4.35 percent of $1,000, or $43.50) less the amount of tax that would have been imposed if the debt obligation which was extended had been acquired in a transaction subject to the tax immediately prior to its extension (no tax, since the debt obligation would have had a maturity of less than 3 years).

Example (3).—On August 5, 1964, C, a U.S. person, acquires for $100 from X, a nonresident alien, an option to purchase for $100 per share 10 shares of stock of O, a foreign corporation. C exercises the option on January 2, 1965, at which time the option has an actual value of $500 and the O stock has an actual value of $150 per share. C incurs a tax upon the acquisition of the option of $15 (15 percent of $100). In addition, C incurs a tax on the exercise of the option of $150, representing the amount of tax imposed on the actual value of the stock acquired (15 percent of $1,500, or $225) less the amount of tax that would have been imposed if the option had been acquired in a transaction subject to tax immediately prior to its exercise (15 percent of $500, or $75).

Example (4).—D, a U.S. person owning stock of P, a foreign corporation, receives from P, as a distribution with respect to such stock, rights to purchase 100 additional shares of P stock at a price of $20 per share. The rights are valid for a period of 1 year from the date of distribution to the shareholder. D incurs no tax on the distribution of the rights. D exercises such rights at a time when the actual value of P stock is $30 per share and the actual value of such rights equals $10 per share. D incurs a tax of $300, representing the amount of tax imposed on the actual value of the stock acquired (15 percent of $3,000, or $450) less the amount of tax that would have been imposed if the rights had been acquired in a transaction subject to tax immediately prior to their exercise (15 percent of $1,000 or $150).

Special limitations

Paragraph (3) of section 4913(a) provides special limitations on the amount of tax imposed on certain types of acquisitions.

Conversion of debt obligations into stock

Paragraph (3)(A) of section 4913(a) provides a limitation on the tax imposed on the acquisition of stock pursuant to the exercise of a right to convert a debt obligation (as defined in sec 4920(a)(1)) into stock, where the person exercising such right (or, in certain cases, a decedent) was liable for tax on his acquisition of the debt obligation. The tax imposed upon such an acquisition is limited to the amount of tax which would have been imposed under section 4911 if the debt obligation had been treated as stock at the time of its acquisition by the person exercising the right (or by a decedent from whom such person acquired the right by bequest or inheritance or by reason of such decendent's death), less the amount of tax paid by the person (or such decedent) exercising the right as a result of the acquisition of the debt obligation. (The third sentence of sec. 4912(a) treats the exercise of a right to convert a debt obligation into stock as an acquisition of stock from the foreign issuer.)

The application of section 4913(a)(3)(A) is illustrated by the following example:

Example. On January 2, 1964, A, a U.S. person, purchases from nonresident alien X a debt obligation of foreign corporation N. The debt obligation has a period remaining to maturity of 10 years at the time of its acquisition by A and has a conversion privilege which is effective for the full 10-year period. A pays $1,000 for this debt obligation and also pays an interest equalization tax of $77 (7.70 percent of $1,000). In June 1964, A exercises the conversion privilege and exchanges the debt obligation for 200 shares of stock of N. At the time of the conversion, 200 shares of the stock of N have an actual value of $1,500. Under the special rule of section 4913(a)(3)(A), A is liable for an additional tax of $73 (15 percent of $1,000, less the $77 already paid).

Exercise of certain shareholders' rights

Paragraph (3)(B) of section 4913(a) states the special rule that the tax imposed by section 4911 upon the acquisition of foreign stock or debt obligations as a result of the exercise of certain rights of a shareholder in a foreign corporation to subscribe for additional shares of its stock or debt obligations is limited to the amount of tax which would be imposed by section 4911 if the price paid upon exercise of such option or right were the actual value of the stock or debt obligation acquired. The rights covered under paragraph (3)(B) are those which are distributed to a shareholder with respect to his stock and which by their terms must expire or terminate within a period not exceeding 90 days from the date on which the rights are so distributed. (The general rule and general limitation set forth in pars. (1) and (2) of sec. 4913(a) are applicable if the right involved is exercised by a person other than the shareholder to whom it was distributed, or if the right by its terms need not expire or terminate within the 90-day period.)

The application of section 4913(a)(3)(B) is illustrated by the following example:

Example.—A, a U.S. person, receives in a distribution with respect to 100 shares of stock he owns in N, a foreign corporation, the right to subscribe for 1 new share of the stock of N for each 5 shares he owns. The right by its terms expires on the 60th day after distribution. A exercises the right and acquires 20 new shares of N stock at a purchase price of $200. Under the special rule of paragraph (3)(B), A incurs a tax of $30 (15 percent of the $200 paid for the new stock).

Certain employee stock options

Paragraph (3)(C) of section 4913(a) provides that the tax imposed by section 4911 upon an acquisition of stock of a foreign issuer by a U.S. person pursuant to the exercise of an option or similar right described in section 4914(a)(7) is limited to the amount of tax which would have been imposed under section 4911 if the price paid for such stock were its actual value. Thus, the tax imposed upon the exercise of an employee's stock option described in section 4914 (a)(7) is based on the option price.

(*b*) *Certain transfers which are deemed acquisitions.*—Section 4913(b) provides a limitation on the amount of tax imposed in a transfer to which either section 4912(b) (1) or (2) applies. The amount of tax thus imposed as a result of the transfer of property to a foreign trust, corporation, or partnership, as the case may be, is limited to that imposed by section 4911, less the amount of tax paid by the transferor as a result of the transfer being otherwise taxable as an acquisition under chapter 41. The application of this rule is illustrated by the following example:

Example.—A, a U.S. person, transfers $1,000 to a foreign trust in exchange for a 5-year debt obligation of such trust. A pays an interest equalization tax of $43.50 (4.35 percent of $1,000) as a result of the acquisition of such debt obligation. Thereafter, the trust acquires for $1,000 stock of foreign corporation N, the direct acquisition of which by A would have been subject to tax under section 4911. The additional tax for which A is liable is limited to $106.50 (15 percent of $1,000 less the $43.50 already paid).

SECTION 4914. EXCLUSION FOR CERTAIN ACQUISITIONS

(*a*) *Transactions not considered acquisitions.*—Section 4914(a) enumerates certain transactions which are not included in the term "acquisition" for purposes of the interest equalization tax.

Paragraph (1) excludes any transfer between a person and his nominee, custodian, or agent. Thus, the term "acquisition" does not include a transfer of stock or a debt obligation by any person to his broker, or by a broker to his customer, where the broker is not acting for his own account.

Paragraph (2) excludes any transfer described in section 4343(a) of the code, relating to certain transfers by operation of law from decedents, minors, incompetents, financial institutions, bankrupts, successors, foreign governments and aliens, trustees, and survivors.

Paragraph (3) excludes any transfer by legacy, bequest, or inheritance to a U.S. person, as well as any transfer by gift to a U.S. person who is an individual. Inter vivos transfers to trusts or other entities are not excluded.

Paragraph (4) excludes any distribution by a corporation of its stock or debt obligations to a shareholder with respect to or in exchange for its stock. Thus, a stock dividend, distribution of rights, or any other distribution to a stockholder of the distributing corporation's stock or debt obligations—in connection with a reorganization, liquidation, or redemption, or otherwise—is a transfer which is not considered an acquisition, whether or not it is subject to Federal income tax. This rule is illustrated by the following examples:

Example (1).—A, a U.S. person, is a shareholder in M, a foreign corporation. M distributes to A as a dividend, with respect to its stock, the right to purchase its debt obligations. A is liable for Federal income tax on the distribution. The receipt by A of the right to purchase the debt obligations of M is not an acquisition for purposes of the interest equalization tax.

Example (2).—The facts are the same as in example (1), except that A receives a further distribution by M (with respect to its stock) of debt obligations of foreign corporations N and O. The acquisition by A of the debt obligations of N and O is not excluded under section 4914(a)(4), since the debt obligations are not those of M.

Example (3).—B, a U.S. person, is a stockholder in P, a domestic corporation. In a transaction to which section 354 applies, B surrenders to P his stock in P in exchange for voting stock of R, a foreign corporation. Under the special rule of section 4912(b)(4), B is deemed to have acquired the R stock in a distribution by R to B in exchange for stock of R. The acquisition by B is not considered to be a taxable acquisition.

Paragraph (5) of section 4914(a) excludes any exchange to which section 361 applies (or would apply but for section 367), where the transferor corporation was a domestic corporation engaged in the active conduct of a trade or business, other than as a dealer in stock or securities, immediately before the date on which the assets involved are transferred to the acquiring corporation. The application of paragraph (5) is illustrated by the following examples:

Example (1).—On September 3, 1964, X, a domestic corporation which is engaged in the active conduct of a manufacturing business, transfers all of its assets to M, a foreign corporation, in exchange for voting stock of M. Immediately following the transaction, X owns 7 percent of such voting stock. Although no section 367 ruling is obtained, the transaction is one described in section 361. X is not considered as having made an acquisition of the stock of M for purposes of the interest equalization tax.

Example (2).—On October 6, 1964, N, a foreign corporation, transfers substantially all of its assets to Y, a domestic corporation, in exchange for voting stock in Y. The transaction is one described in section 361, and the Commissioner of Internal Revenue prior to the transaction has ruled under section 367 that avoidance of Federal income taxes was not one of its principal purposes. Included in the assets transferred by N are stock and debt obligations of foreign corporations O, P, and R, none of which is a party to the reorganization. The receipt by Y of the stock and debt obligations of O, P, and R is not excluded under section 4914(a)(5) since N, the transferor corporation, is not a domestic corporation.

Paragraph (6) of section 4914(a) excludes any exercise of a right to convert an indebtedness, pursuant to its terms, into stock, if such

indebtedness was treated as stock pursuant to the provisions of section 4920(a)(2)(D). Thus, if a convertible debt obligation is one which is classified as stock in accordance with the special rule of section 4920(a)(2)(D), no tax under chapter 41 will be imposed upon the exercise of the conversion right. (For the treatment under ch. 41 of stock acquired as the result of the exercise of the right to convert a debt obligation (as defined) into stock, see sections 4912(a) and 4913(a)(3).)

Paragraph (7) of section 4914(a) excludes the grant of a stock option or similar right to a U.S. person who is an individual, for any reason connected with his employment by a corporation, if such option or right (A) is granted by the employer corporation, or by its parent or subsidiary corporation, to purchase stock of any of such corporations, and (B) by its terms is not transferable by such U.S. person otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him. This paragraph does not apply to any option or right other than the employee stock options described. The tax imposed on the exercise of an employee stock option or similar right so acquired is determined under section 4913(a)(3)(C). For an exclusion from the tax of acquisitions occurring upon the exercise of certain options or similar rights held on July 18, 1963, see section 2(c)(6) of the bill.

(*b*) *Excluded acquisitions.*—Section 4914(b) enumerates certain acquisitions to which the interest equalization tax does not apply.

Paragraph (1) of section 4914(b) excludes acquisitions of stock or debt obligations by any agency or wholly-owned instrumentality of the United States. For example, acquisitions by the Export-Import Bank are excluded.

Paragraph (2)(A) of section 4914(b) excludes acquisitions of debt obligations by a commercial bank if the bank acquires the debt obligations in the ordinary course of its commercial banking business. Paragraph (2)(B) excludes acquisitions of stock or debt obligations by a commercial bank through foreclosure, where such stock or debt obligations were held as security for loans made in the ordinary course of its commercial banking business. The exclusion provided by paragraph (2) does not extend to trust companies or other financial institutions not regularly engaged in accepting deposits from customers and performing other functions related to the commercial banking business, or to acquisitions by a commercial bank for its investment portfolio; however, if a person is engaged both in the commercial banking business and in other businesses or activities, those acquisitions related solely to the commercial banking business (but no others) are excluded. A corporation organized under section 25(a) of the Federal Reserve Act (commonly known as the Edge Act), or a State-chartered corporation operating under an agreement with the Federal Reserve Board under section 25 of the Federal Reserve Act, will be considered a commercial bank for this purpose if it is regularly engaged in accepting deposits from customers.

Loans made in the ordinary course of a commercial banking business may take a wide variety of forms and may be made for a multitude of purposes. While past practices are not necessarily determinative, the conduct of the business of a commercial bank in the past, as well as the ordinary course of business by other banks similarly situated, is

indicative of what will constitute loans made in the ordinary course of a commercial banking business.

Paragraph (3) of section 4914(b) excludes any acquisition of stock or debt obligations by a U.S. person doing business in a foreign country to the extent that such acquisition is reasonably necessary to satisfy minimum requirements relating to holdings of stock or debt obligations of foreign issuers or obligors imposed by the laws of such foreign country. This will exclude from the tax acquisitions by insurance companies (except as limited in the manner discussed below), banks, and others who are required to make deposits of, or otherwise hold, stock or debt obligations of foreign issuers or obligors in connection with business carried on by their foreign branches. The exclusion applies to acquisitions in amounts reasonably required to comply with legal requirements, whether such requirements are expressly set forth by statute or are imposed by administrative action under applicable laws. It is limited in amount to holdings of foreign securities required by the laws or administrative regulations in force at the time of the acquisition involved.

If any of the requirements imposed by foreign laws relates to the holding of insurance reserves, the exclusion otherwise allowable under section 4914(b)(3) with respect to acquisitions by an insurance company during any calendar year is reduced by the maximum amount of the exclusion which could be allowed under section 4914(c) (discussed below) with respect to acquisitions made by the insurance company during that year, or by the amount of the insurance reserves which must be held in order to satisfy such requirements, whichever is less. The application of this rule is illustrated by the following example:

Example.—R, a U.S. person, is an insurance company subject to taxation under section 831 of the Code. R insures risks relating to property located in foreign country X, which is the only foreign country in which it is doing business. Pursuant to the laws of X, R is required to acquire and hold foreign securities sufficient to maintain insurance reserves equal to 120 percent of the unearned premiums and unpaid losses with respect to its insurance and reinsurance of risks located in X. Accordingly, R makes acquisitions of foreign stock and debt obligations during the calendar year 1964 in sufficient amounts so that it holds foreign securities at all times during the year equal to 120 percent of the insurance reserves required by X. Since, under section 4914(c), R would be entitled to exclude up to 110 percent of its allowable insurance reserve determined under that section with respect to the insurance of X risks, only the additional acquisitions of foreign securities required to be made in order to comply with X's laws are excludable under section 4914(b)(3).

Paragraphs (4) through (7) of section 4914(b) contain references to the exclusions provided by section 4914(c) through (f) (discussed below).

(c) *Export credit, etc., transactions.*—Section 4914(c) excludes from the interest equalization tax certain acquisitions of stock and debt obligations arising from the sale of property or services by U.S. persons.

In general

Paragraph (1) of section 4914(c) provides that the acquisition by a U.S. person of a debt obligation arising out of the sale to a foreign obligor of tangible personal property or services (or both) is excluded from tax if—

(A) payment of the obligation is guaranteed or insured, in whole or in part, by an agency or wholly-owned instrumentality of the United States; or

(B) such U.S. person makes the sale in the ordinary course of his trade or business and at least 85 percent of the purchase price is attributable to the sale of property manufactured, produced, grown, or extracted in the United States, or to the performance of services by such U.S. person (or by one or more includible corporations in an affiliated group, as defined in sec. 1504 of the code, of which such person is a member) or to both.

The acquisition of a debt obligation, payment of which is guaranteed or insured in whole or in part by the Export-Import Bank (or any other agency or wholly-owned instrumentality of the United States) is excluded from tax under paragraph (1)(A). Paragraph (1)(B) provides an exclusion from tax for the ordinary business operations of U.S. merchant exporters. The acquisition of stock of a foreign issuer may not be excluded under paragraph (1).

The term "services," as used in section 4914(c) (1) and (2), is not construed to include functions performed as an underwriter.

The application of section 4914(c)(1) is illustrated by the following examples:

Example (1).—A, a domestic corporation, sells machinery to foreign corporation P for $200,000 (in a transaction otherwise taxable under ch. 41), receiving as payment $50,000 in cash and $150,000 in P's 5-year promissory notes. Payment of the notes is guaranteed by the Export-Import Bank. Acquisition of the notes by A is excluded from tax.

Example (2).—M, a domestic corporation, sells an airplane manufactured in the United States to X, a foreign corporation, for a total price of $1 million (in a transaction otherwise taxable under ch. 41), receiving as payment $100,000 in cash and $900,000 in X's 10-year promissory notes. The acquisition by M is excluded from tax.

Example (3).—N, a U.S. person, is engaged in business as a merchant exporter. In the ordinary course of such business N sells equipment to foreign corporation Y, for $100,000 (in a transaction otherwise taxable under ch. 41), receiving as payment $30,000 in cash and $70,000 in Y's 5-year notes. Of the $100,000 purchase price, $90,000 represents the fair market value of the equipment, which was manufactured in the United States, and $10,000 is attributable to assembly and installation operations performed at the destination by a local contractor on behalf of N. The acquisition of the notes by N is excluded from tax.

Alternate rule for producing exporters

Paragraph (2) of section 4914(c) provides that the acquisition by a U.S. person from a foreign issuer or obligor of its stock or debt obligation is excluded from tax if the stock is received in payment for, or the debt obligation arises out of, the sale of tangible personal property or services (or both) to such issuer or obligor and if—

(A) at least 30 percent of the purchase price in the transaction is attributable to the sale of property manufactured, produced, grown, or extracted in the United States by such U.S. person (or by one or more includible corporations in an affiliated group, as defined in section 1504 of the code, of which such person is a member), or to the performance of services by such U.S. person (or by one or more such corporations), or to both, and

(B) at least 50 percent of the purchase price is attributable to the sale of property manufactured, produced, grown, or extracted in the United States, or the performance of services by U.S. persons, or both.

Goods and services sold by the U.S. person acquiring the stock or debt obligation involved are counted in meeting the 50 percent requirement (as well as the 30 percent test) and U.S. goods and services provided by others are also counted. Where a U.S. person, such as a construction engineer, acts as contractor for the performance of services, amounts attributable to services performed by such person or employees of such person (whether or not within the United States) are included in determining whether the 30 percent and 50 percent tests are met; but amounts attributable to services performed by subcontractors who are not U.S. persons are not counted.

The application of section 4914(c)(2) is illustrated by the following examples:

Example (1).—A, a domestic corporation, is in the business of manufacturing electrical equipment in the United States. Corporation A contracts to sell such equipment to foreign corporation P and to arrange for the construction of a plant to house the equipment. P agrees to pay A a total purchase price of $1 million—$200,000 in cash and $800,000 in P's 5-year promissory notes. The value of the electrical equipment sold by A is $250,000 and services provided by a wholly owned domestic subsidiary of A are valued at $100,000. B, a domestic corporation, supplies construction materials manufactured in the United States and valued at $100,000 and services valued at $50,000. The acquisition by A of the notes of P is excluded from tax.

Example (2).—B, a domestic corporation, is a construction engineering firm. B contracts with foreign corporation R for the construction of a plant for $100,000, receiving as payment $30,000 in cash, $50,000 in R's 5-year promissory notes, and $20,000 in R's stock. B subcontracts to foreign corporation S the performance of services in connection with the construction of a road leading to the plant; these services have a value of $20,000. The acquisition by B of the debt obligations and stock of R is excluded from tax.

Export-related loans

Paragraph (3) of section 4914(c) provides that the acquisition of a debt obligation by a U.S. person from a foreign obligor is excluded from tax if the obligation arises out of a loan to increase or maintain sales of tangible personal property manufactured, produced, grown, or extracted in the United States by such U.S. person (or by one or more includible corporations in an affiliated group, as defined in section 1504 of the code, of which such person is a member), and if the proceeds of the loan will be used by the obligor for the installation, maintenance, or improvement of facilities outside the United States which will be used for the storage, handling, transportation, processing, packaging, or servicing of property a substantial portion

of which is the tangible personal property referred to above. A loan will not qualify for this exclusion unless the foreign obligor is committed to invest the proceeds of the loan for the stated purpose. Whether property sold by a U.S. person (or an includible corporation) constitutes a "substantial portion" of all of the property with respect to which a facility is used will depend on the percentage which the property so sold is of the total of all of such property, and not on the absolute dollar amount of such sales. The determination will be made by reference to the reasonably anticipated use to be made of the facility over the period during which the loan to be excluded will be outstanding.

The application of section 4914(c)(3) is illustrated by the following example:

Example.—A, a domestic corporation, is engaged in the business of producing steel in the United States. Over a period of several years A has sold to foreign corporation X approximately 40 percent of the steel fabricated by X in its plant in foreign country Q, and reasonably anticipates that this relationship will continue indefinitely. In the interest of increasing or maintaining these sales, A agrees to lend X $500,000, and X agrees to use the proceeds to construct new steel fabricating facilities at such plant. A receives 10-year promissory notes from X in return for the loan. The acquisition of these notes is excluded from the tax.

Other loans related to certain sales by U.S. persons

Paragraph (4) of section 4914(c) provides that an acquisition by a U.S. person of a debt obligation from a foreign obligor is excluded from tax if the debt obligation—

(A) was received by the U.S. person as all or part of the purchase price provided in a contract under which the foreign obligor agrees to purchase for 3 years or more ores or minerals (or derivatives thereof) extracted outside the United States by the U.S. person, by one or more includible corporations in an affiliated group (as defined in sec. 48(c)(3)(C) of the code) of which such person is a member, or by a corporation at least 10 percent of whose voting stock is owned by such U.S. person (but only if at least 50 percent of such voting stock is owned by U.S. persons each of whom owns at least 10 percent); or

(B) arises out of a loan, made by the U.S. person to the foreign obligor, the proceeds of which will be used by the obligor for the installation, maintenance, or improvement of facilities outside the United States which will be used for the storage, handling, transportation, processing, or servicing of ores or minerals (or derivatives thereof) a substantial portion of which is extracted outside the United States by any of the persons or corporations described in subparagraph (A).

Paragraph (4)(A) of section 4914(c) is applicable to credit extended in connection with supply contracts of the type described, but not to any cash loan which may be made in connection with such a contract. Paragraph (4)(B) is applicable to cash loans, but only when the proceeds are used for the stated purpose. With respect to paragraph (4)(B), whether property sold by any person constitutes a "substantial portion" of all of the property with respect to which a facility is used will depend on the percentage which the property so sold is of the

total of all of such property, and not on the absolute dollar amount of such sales. The determination will be made by reference to the reasonably anticipated use to be made of the facility over the period during which the loan to be excluded will be outstanding.

Neither paragraph (4)(A) nor (4)(B) applies to the acquisition of stock of the foreign person involved or of debt obligations of any other person.

The application of section 4914(c)(4) is illustrated by the following examples:

Example (1).—A is a domestic corporation engaged in the business of selling crude and refined oil. A enters into an agreement under which it sells heating oil to foreign corporation M over a period of 10 years for a total consideration of $5 million. In partial payment of the contract price, A receives M's 10-year promissory notes in the amount of $2,500,000. The oil is extracted outside the United States by a corporation of which A owns 30 percent of the combined voting power of all classes of stock and U.S. person B owns an additional 20 percent. The acquisition by A of the notes is excluded from the tax.

Example (2).—The facts are the same as in example (1), except that A also agrees to make to foreign corporation M a $1 million loan, the proceeds of which M agrees to use for construction of a refinery. In return, A receives M's 10-year promissory notes. During the period in which the loan is to be outstanding, 35 percent of the oil refined in the facility which M constructs is to be supplied by A under the contract referred to in example (1). The acquisition by A of the notes is excluded from the tax.

Cross reference

Paragraph (5) of section 4914(c) contains a cross reference to section 4914(g), which provides in effect that (except for the exclusion contained in sec. 4914(c)(1)(A), relating to loans guaranteed or insured by an agency or wholly-owned instrumentality of the U.S. Government) any of the exclusions allowed under section 4914(c) may be lost as a result of certain subsequent transfers.

(d) *Loans to assure raw materials sources.*—Section 4914(d) excludes from tax the acquisition of debt obligations where the borrowing foreign corporation extracts or processes certain ores or minerals and where the loan made by the U.S. person will be amortized under so-called "take or pay" contracts entered into by the shareholders of the foreign corporation.

General rule

Paragraph (1) of section 4914(d) requires, in order for the exclusion to apply, that the foreign obligor extract or process ores or minerals the available deposits of which in the United States are inadequate to satisfy the needs of domestic producers, and that U.S. persons directly own at least 50 percent of the total combined voting power of all classes of stock of the foreign corporation at the time of the acquisition involved. It further requires that the loan be amortizable under a contract or contracts in which stockholders of the foreign corporation (including at least one U.S. person) agree to pay during the period remaining to maturity of the obligation, by purchasing a part of the production of such corporation or otherwise, a portion of

the corporation's costs of operation and costs of amortizing outstanding loans.

Limitation

Paragraph (2) of section 4914(d) limits the total exclusions allowable under section 4914(d)(1) to the amount by which the "applicable percentage" of the aggregate actual value of the debt obligation acquired and all other debt obligations representing loans theretofore made to the foreign corporation (by both U.S. and foreign persons) during the same calendar year which are amortizable under "take or pay" contracts exceeds the actual value of similar debt obligations the acquisition of which by any U.S. person has been excluded from tax under section 4914(d) during the same calendar year. For this purpose the term "applicable percentage" means the lesser of (A) the percentage of the total combined voting power of all classes of stock of the foreign corporation which is owned by U.S. persons at the time of the acquisition involved, or (B) the percentage of the corporation's operating and amortization costs for the calendar year which all such U.S. persons have agreed to pay. The application of section 4914(d) is illustrated by the following example:

Example.—A, a domestic corporation, owns 60 percent of the only class of the outstanding stock of foreign corporation M. The remaining stock of M is owned by other foreign corporations. M is engaged in foreign country X in the processing of bauxite into alumina. The deposits of bauxite in the United States are inadequate to supply the needs of U.S. producers of aluminum for alumina.

A enters into a "take or pay" contract with M under which A agrees (subject to a clause permitting termination of payments in case of intervening *force majeure*) to purchase 60 percent of M's alumina production, or in lieu thereof to pay 60 percent of an amount equal to M's costs of operation and costs of amortizing outstanding loans. Similar contracts are entered into by the other shareholders of M. The following loans are made to M:

Lender	Amount	Date
Foreign corporation B	$500,000	Dec. 15, 1964
Foreign corporation C	1,000,000	Jan. 15, 1965
Domestic corporation D	2,000,000	Feb. 1, 1965
Domestic corporation E	1,000,000	Feb. 15, 1965

All of these loans are amortizable under the "take or pay" contracts described above. All are repayable on December 31, 1974, except the loan made by D, which is repayable on December 31, 1979. The lenders acquire promissory notes of M in the amounts set forth above, and the notes have an actual value equal to their face value. None of the other exclusions provided by chapter 41 is applicable.

D may exclude its acquisition from tax under the provisions of section 4914(d) only to the extent of $1,800,000 (60 percent of $3 million). D is liable for a tax of $20,600 (10.30 percent of $200,000).

E may exclude its acquisition from tax under such provisions only to the extent of $600,000 (60 percent of $4 million, or $2,400,000, less the $1,800,000 previously excluded by D). E is liable for a tax of $30,800 (7.70 percent of $400,000).

The exclusion allowed by section 4914(d) may in effect be lost as a result of certain subsequent transfers. The conditions under which the exclusion may be lost are set forth in section 4914(g).

(e) *Acquisitions by insurance companies doing business in foreign countries.* Section 4914(e) excludes from tax the acquisition of certain stock and debt obligations by insurance companies doing business in foreign countries.

In general

Paragraph (1) of section 4914(e) states the general rule that the tax imposed by section 4911 does not apply to the acquisition of stock or a debt obligation by a U.S. person which is an insurance company subject to income taxation under section 802, 821, or 831 of the code if it meets the conditions and requirements set forth in section 4914(e). In general, the tax will not apply to an acquisition if—

(A) the stock or debt obligation acquired is designated as part of a fund of assets established and maintained by the insurance company with respect to foreign risks insured or reinsured by such company under contracts (including annuity contracts) which, by their terms, provide that the proceeds will be payable only in the currency of a foreign country; and

(B) the actual value of all of the assets held in such fund immediately after the stock or debt obligation has been designated as a part thereof does not exceed 110 percent of the applicable allowable reserve of such company.

The term "foreign risks," for purposes of section 4914(e), means risks in connection with property outside, or liability arising out of activity outside, or in connection with the lives or health of residents of countries other than, the United States.

Establishment and maintenance of fund of assets

Paragraph (2) of section 4914(e) provides that an insurance company which desires to obtain the benefit of exclusions under such section shall, as a condition of entitlement to any such exclusion, establish and maintain a fund (or funds) of assets. A life insurance company (as defined in sec. 801(a) of the code) must establish a fund of assets separately for each foreign currency (other than the currency of a country which qualifies as a less developed country) in which the proceeds of its insurance contracts are payable and for which insurance reserves are maintained by such company, and with respect to which it desires to obtain the benefits of such exclusions. Each such fund must separately meet the requirements of section 4914(e). An insurance company other than a life insurance company (as so defined) must establish a single fund of assets for all foreign currencies (other than currencies of countries which qualify as less developed countries at the time of the initial designation) in which the proceeds of its insurance contracts are payable and for which insurance reserves are maintained by such company, if it desires to obtain the benefits of exclusions under section 4914(e).

Designation of assets

Paragraph (3) of section 4914(e) contains three subparagraphs; subparagraph (A) provides rules for the initial designation of assets constituting a fund, subparagraph (B) provides rules for additional designations of assets after the initial designation, and subparagraph

(C) provides a limitation on the designations permitted. (Under sec. 4914(g)(2), if an insurance company designates (or is required to designate) stock or a debt obligation under sec. 4914(e), it will not thereafter be considered a U.S. person with respect to that stock or debt obligation.)

Initial designation

Paragraph (3)(A) requires that an insurance company desiring to establish a fund (or funds) of assets under paragraph (2) must initially designate, as part or all of such fund (or funds), stock of foreign issuers, or debt obligations of foreign obligors having a period remaining to maturity (as of December 10, 1963) of 3 years or more, or both, which it owned on December 10, 1963, to the extent that such stock and debt obligations had an actual value as of such date not in excess (in the case of any such fund) of 110 percent of the applicable allowable reserve as determined in accordance with paragraph (4)(A). The designation or designations which an insurance company is thus required to make must be made first from stock and debt obligations which were acquired by such company on or before July 18, 1963, and must not include any stock or debt obligation described in section 4916(a) (relating to less developed countries, less developed country corporations, etc.). Any initial designation which an insurance company is required to make under paragraph (3)(A) must be made on or before the 30th day after the date of the enactment of the new chapter 41 (or at such later time as the Secretary of the Treasury or his delegate may by regulations prescribe) by the segregation on the books of such company of the stock or debt obligations (or both) designated.

Designations to maintain fund

Paragraph (3)(B) provides that, to the extent permitted by paragraph (3)(C), an insurance company may claim an exclusion under section 4914(e) with respect to the acquisition of stock or a debt obligation of a foreign issuer or obligor after December 10, 1963, if such company designates such stock or debt obligation as part of a fund of assets described in paragraph (2) before the expiration of 30 days after the date of such acquisition (and continues to own it until the time the designation is made); except that any such stock or debt obligation acquired before the initial designation of assets to the fund is actually made by segregating such assets on the books of the company as described above may be designated under paragraph (3)(B) at the time of such initial designation without regard to the 30-day and continued ownership requirements.

Limitation

Paragraph (3)(C) provides that no designation of stock or a debt obligation as a part of a fund of assets may be made under paragraph (3) (A) or (B) to the extent that, immediately thereafter, the actual value of all of the assets held in such fund would exceed 110 percent of the applicable allowable reserve determined in accordance with paragraph (4).

Determination of reserves

Paragraph (4)(A) of section 4914(e) provides that, for purposes of section 4914(e), the term "allowable reserve" means—

(1) in the case of a life insurance company (as defined in sec. 801(a) of the code), the items taken into account under section 810(c) of the code arising out of contracts of insurance and reinsurance (including annuity contracts) which relate to foreign risks and the proceeds of which are payable in a single foreign currency (other than the currency of a less developed country); and

(2) in the case of an insurance company other than a life insurance company (as so defined), the amount of its unearned premiums and unpaid losses which relate to foreign risks insured or reinsured under contracts providing for payment in foreign currencies (other than currencies of less developed countries), and which are taken into account in computing taxable income under section 832(b) (4) and (5) of the code (for such purpose treating underwriting income of an insurance company subject to taxation under sec. 821 of the code as taxable income under sec. 832).

The determination of an allowable reserve of an insurance company for any calendar year is made as of the close of the previous calendar year, except as provided in paragraph (4)(B).

Paragraph (4)(B) provides that an insurance company which has established a fund of assets under section 4914(c) may elect, in such manner and form as the Secretary of the Treasury or his delegate shall prescribe in regulations and on or before the date that such company is required under section 6076 of the code to file its return for the period in which the last day of any calendar year occurs, to make the determination of the allowable reserve with respect to such year as of the close of such year. At the time of making such election, the company may (if the allowable reserve as so determined is higher than as determined under par. (4)(A)) designate additional stock or debt obligations (or both) as part of such fund, so long as the company still owns such stock or debt obligations at the time of designation and the actual value of all of the assets held in such fund is not increased to more than 110 percent of the allowable reserve applicable to such fund as determined under paragraph (4)(B). In the case of a life insurance company (as defined in sec. 801(a) of the code), the election under paragraph (4)(B) is made separately with respect to each fund of assets established as provided in section 4914(c)(2). Any tax paid by the company under section 4911 on the acquisition of the additional stock or debt obligations so designated will constitute an overpayment of tax; and, under regulations prescribed by the Secretary of the Treasury or his delegate, credit or refund (without interest) will be allowed or made with respect to such overpayment.

Nonrecognition of artificial increases in allowable reserve

Paragraph (5) of section 4914(c) provides that an insurance or reinsurance contract which is entered into or acquired by an insurance company for the principal purpose of artificially increasing the amount determined as an allowable reserve as provided in paragraph (4) of such section will not be recognized in computing whether an acquisition of stock or a debt obligation of a foreign issuer or obligor can be excluded under section 4914(c). The facts and circumstances of each case will be considered in determining whether the principal purpose was to artificially increase the amount of an allowable reserve.

The operation of section 4914(e) is illustrated by the following examples:

Example (1).—R is a domestic insurance company subject to income taxation under section 802 of the code. R insures the lives of residents of foreign country X, under contracts the proceeds of which are payable only in the currency of that country. As of the close of calendar year 1962, $500,000 was the amount of R's allowable reserve, computed in accordance with paragraph (4)(A) of section 4914(e), with respect to such contracts. R also insures the lives of residents of foreign country Y under contracts the proceeds of which are payable only in its currency. As of the same date, $200,000 was the amount of the allowable reserve, similarly computed, with respect to such contracts.

On December 10, 1963, R owned the following foreign securities, each having as of that date the period remaining to maturity and the actual value indicated:

Security	Period to maturity (years)	Actual value
(1) Bonds of foreign corporation A	10	$200,000
(2) Notes of foreign country X	2	50,000
(3) Bonds of foreign corporation B	15	100,000
(4) Stock of foreign corporation C	----------	125,000

All of such securities had been acquired by R on or before July 18, 1963.

During the period from July 19, 1963, through December 10, 1963, R engaged in the following transactions:

(*a*) On July 24, 1963, R acquired a 5-year debt obligation of foreign corporation D, having an actual value on that date of $2,000; and on September 10, 1963, R sold that debt obligation.

(*b*) On July 29, 1963, R acquired a debt obligation of foreign corporation E, maturing on November 30, 1966, and having an actual value when acquired of $5,000.

(*c*) On August 27, 1963, R acquired 500 shares of stock of foreign corporation F having an actual value on that date of $18,000 and an actual value on December 10, 1963, of $20,000.

(*d*) On September 2, 1963, R acquired 10-year bonds of foreign government Y having an actual value of $100,000 both at the time of acquisition and on December 10, 1963.

R desires to obtain the benefit of exclusions under section 4914(e) and therefore on December 31, 1963, establishes two funds of assets, one with respect to the risks insured in foreign country X and the other with respect to the risks insured in foreign country Y, by segregating on its books (in accordance with sec. 4914(e)(3)(A)(i)) the assets which are required to be designated as part of each fund. (None of the other exclusions or exemptions provided by ch. 41 is applicable.)

Before it may designate any other assets, R must designate the bonds of foreign corporation A, the bonds of foreign corporation B and the stock of foreign corporation C. R may not designate the notes of foreign country X, since they had a period remaining to

maturity of less then 3 years on December 10, 1963. R makes the following designations:

	Currency X fund	Currency Y fund
Allowable reserve	$550,000	$220,000
Initial designation:		
(1) Bonds of foreign corporation A	200,000	
(2) Bonds of foreign corporation B		100,000
(3) Stock of foreign corporation C	50,000	75,000
Total	250,000	175,000
Amount remaining to be designated	300,000	45,000

In making further designations, R is not permitted to designate the 5-year debt obligation of foreign corporation D, since it was not owned by R on December 10, 1963. It is also not permitted to designate the debt obligation of foreign corporation E, since on December 10, 1963, the debt obligation had a period remaining to maturity of less than 3 years. R must designate the 500 shares of stock of corporation F and the bonds of foreign country Y. R makes the following designations:

	Currency X fund	Currency Y fund
(1) Stock of foreign corporation F	$20,000	
(2) Bonds of foreign country Y	55,000	$45,000
Total, initial designation	325,000	220,000

Example (2).—The facts are the same as in example (1), and R has made the initial designations described therein. R now desires to designate additional foreign stock and debt obligations which it has acquired after December 10, 1963. R engaged in the following foreign security transactions after December 10, 1963, and prior to January 1, 1964:

(*a*) On December 21, 1963, R acquired a 5-year debt obligation of foreign corporation H, which had an actual value of $10,000; this was sold on December 27, 1963.

(*b*) On December 24, 1963, R acquired stock in foreign corporation J, which had an actual value of $20,000.

(*c*) On December 26, 1963, R acquired a 15-year debt obligation of foreign corporation K, which had an actual value of $5,000.

Under section 4914(c)(3)(B), R may maintain the funds it has established by designating additional assets as part of the funds to the extent allowed under section 4914(c). The 5-year debt obligation of H, which was sold on December 27, 1963, may be designated by R despite the fact it is not owned by R on December 31, 1963, if such designation is made on December 31, 1963, at the time of the initial designation of assets. The stock acquired by R on December 24, 1963, and the debt obligation acquired by R on December 26, 1963, may also be designated by R as part of a fund on December 31, 1963, or on any date thereafter (up to 30 days after the date of acquisition) on which they are owned by R. Accordingly, R designates the debt obligation of H, the stock of J, and the debt obligation of K as part

of the fund established with respect to risks insured in foreign country X.

Example (3).—The facts are the same as in example (1). R, after making the initial designation of assets in the funds established for currency X and currency Y, makes other acquisitions of foreign securities during the calendar year 1964. As of the close of the calendar year 1963, $600,000 is the allowable reserve with respect to risks payable in the currency of foreign country X.

On June 10, 1964, R acquires a 10-year debt obligation of foreign corporation P, having an actual value of $10,000. At the time of such acquisition the actual values of the assets in the X currency fund and the Y currency fund are such that the designation of the P debt obligation would bring the total actual value of the assets of each such fund to an amount greater than 110 percent of their respective allowable reserves. Accordingly, R is not able to designate the P debt obligation as part of a fund of assets under section 4914(e). R thus is required to (and does) pay an interest equalization tax of $770 (7.70 percent of $10,000) with respect to its acquisition of the debt obligation of P.

However, R continues to hold the P debt obligation and on January 25, 1965, files its return with respect to transactions which occurred during the last quarter of the calendar year 1964. At such time R determines that the amount of its allowable reserve as of the close of the calendar year 1964 with respect to currency X risks was $620,000. The actual value of the P debt obligation on January 25, 1965, was $12,000, and the actual value of all assets held in the X fund on that date was $640,000. Under the special election provided in section 4914(e)(4)(B), R may designate the P debt obligation as an asset of the X fund since such designation would not raise the total actual value of the X fund assets on January 25 above $682,000 (110 percent of $620,000). Pursuant to regulations prescribed by the Secretary of the Treasury or his delegate, R is permitted to obtain a refund or credit of the $770 tax paid on the acquisition of the debt obligation of P.

(*f*) *Acquisitions by certain tax-exempt labor, fraternal, and similar organizations having foreign branches or chapters.*—Section 4914(f) provides that the tax imposed by section 4911 does not apply to the acquisition of stock or debt obligations by a U.S. person which is described in section 501(c) of the code, is exempt from taxation under subtitle A of the code, and operates in a foreign country through a local organization or organizations, to the extent that such acquisition results from the investment or reinvestment of contributions or membership fees paid in the currency of such country by individuals who are members of the local organization or organizations, and the stock or debt obligations acquired are held exclusively for the benefit of the members of any of such local organizations. The term "local organizations" includes all branches, chapters, and similar entities, located and operating in a foreign country, which are chartered by, or affiliated or associated with, the parent or central organization, and subject to the general supervision of, and examination by, such parent or central organization. The term "membership fees" covers dues, fees, and assessments which are paid by the local membership; however, premiums (including deposits and assessments) paid to a mutual insurance company or association referred to in section 501(c)(15) of the code are not considered membership fees or contributions. A

U.S. person will meet the exclusive holding requirements of section 4914(f) if the stock or debt obligations involved are held exclusively for the benefit of the members of any or all of the local organizations in the particular foreign country.

An exclusion allowed under section 4914(f) may, in effect, be lost as a result of certain subsequent transfers. The conditions under which the exclusion may be lost are set forth in section 4914(g).

(*g*) *Loss of entitlement to exclusion in case of certain subsequent transfers.*—Section 4914(g) provides in effect for the loss by U.S. persons of the benefits of certain exclusions previously allowed under section 4914 upon subsequent transfers of the stock or debt obligations involved.

In general

Paragraph (1) of section 4914(g) sets forth provisions relating to the loss of the exclusions provided in section 4914 (c), (d), and (f) upon the subsequent transfer of the debt obligation or stock involved.

In the case of the exclusion of a debt obligation from tax under the provisions of section 4914(c) (relating to export credit, etc., transactions), other than paragraph (1)(A) thereof (relating to debt obligations guaranteed or insured by an agency or instrumentality of the United States), or under the provisions of section 4914(d) (relating to loans to assure raw materials sources), the acquiring person becomes liable for tax under section 4911 if the debt obligation is subsequently transferred by him before the termination of the tax to any U.S. person otherwise than—

(A) to an agency or wholly-owned instrumentality of the United States;

(B) to a commercial bank acquiring the obligation in the ordinary course of its commercial banking business; or

(C) in a transaction described in section 4914(a)(1) (transfers between a person and his nominee, custodian, or agent), a transaction described in section 4914(a)(2) (certain transfers by operation of law as enumerated in sec. 4343(a) of the code), or a transaction (other than a transfer by gift) described in section 4914(a)(3) (transfers by legacy, bequest, or inheritance).

A debt obligation the acquisition of which is excluded from tax under section 4914(c)(1)(A) (because guaranteed or insured by an agency or instrumentality of the United States) may be transferred to any person without loss of the exclusion.

In the case of the exclusion of stock from tax under the provisions of section 4914(c)(2) (alternate rule for producing exporters), the acquiring person becomes liable for tax under section 4911 if the stock is subsequently transferred by him before the termination of the tax to a U.S. person otherwise than in a transaction described in section 4914(a)(1), a transaction described in section 4914(a)(2), or a transaction (other than a transfer by gift) described in section 4914(a)(3).

In the case of the exclusion of stock or a debt obligation from tax under the provisions of section 4914(f) (relating to acquisitions by certain tax-exempt labor, fraternal, and similar organizations having foreign branches or chapters), the acquiring person becomes liable for tax under section 4911 if the stock or debt obligation is subsequently transferred by it before the termination of the tax to any U.S. person.

Where an exclusion is lost under the provisions of section 4914(g)(1) and liability for the tax is incurred by the transferor with respect to the

stock or debt obligation involved, such liability is incurred at the time of the subsequent transfer. The amount of the tax due is equal to the amount of tax for which the transferor would have been liable had the exclusion not originally applied with respect to the acquisition. No liability is imposed under section 4914(g)(1) upon the transferee.

The application of section 4914(g)(1) is illustrated by the following examples:

Example (1).—M, a domestic corporation, on June 15, 1964, sells an airplane manufactured in the United States to X, a foreign corporation, for a total price of $1 million, receiving as payment $100,000 in cash and X's 10-year promissory note having an actual value of $900,000. At that time, the acquisition by M is excluded from tax under section 4914(c)(1)(B). On July 1, 1965, M sells the note to P, a domestic corporation which is not a commercial bank, for $800,000. M incurs liability on July 1, 1965, for tax in the amount of $69,300 (7.7 percent of $900,000).

Example (2).—B, a domestic corporation, is a construction engineering firm. On September 1, 1964, B sells its services to foreign corporation R for the construction of a plant for $100,000, receiving as payment $80,000 in cash and stock of R having an actual value of $20,000. At that time, the acquisition by B is excluded from tax under section 4914(c)(2). On February 15, 1965, B sells the stock to P, a domestic corporation which is a commercial bank, for $18,000. B incurs liability on February 15, 1965, for tax in the amount of $3,000 (15 percent of $20,000).

U.S. person treated as foreign person on disposition of certain securities

Paragraph (2) of subsection 4914(g) sets forth a special rule with respect to the disposition by a U.S. person of stock or a debt obligation the acquisition of which by such person was excluded from tax under section 4914(b)(3), or which was designated (or required to be designated) under section 4914(e). If a U.S. person, after December 10, 1963, sells or otherwise disposes of stock or a debt obligation which was so excluded or designated (or required to be designated), such person is not, with respect to that stock or debt obligation, considered a U.S. person. Accordingly, the acquisition of such stock or debt obligation by any other U.S. person is not excluded from tax under section 4918 (relating to prior American ownership).

In cases to which paragraph (2) applies, no liability for tax is imposed upon the U.S. person making the sale or other disposition. Since such person is not considered a U.S. person for this purpose, however, such person may become subject to penalty under section 6681 or 7241 of the code if he executes a certificate of American ownership with respect to such stock or debt obligation or sells such stock or debt obligation under the coverage of a blanket certificate of American ownership.

The application of section 4914(g)(2) is illustrated by the following examples:

Example (1).—R, a life insurance company, establishes a fund of assets with respect to foreign currency X. Under paragraph (3)(A) of section 4914(e), R is required, as part of its initial designation of assets with respect to such fund, to designate 100 shares of P corporation stock which it owns. However, the shares are not at any time so designated. In June 1964, R sells the P stock to a U.S. person.

Under the special rule of section 4914(g)(2), R is treated as a foreign person with respect to such stock and is not able to execute a certificate of American ownership with respect thereto.

Example (2).—B, a U.S. company doing business in foreign country X, is required by the laws of that country to place a deposit of $5,000 in local securities with that government during the time B continues to do business in X. B purchases two 10-year debt obligations of foreign corporation N having a total actual value of $5,000, and deposits these with X. B has an exclusion under section 4914(b)(3) with respect to these two acquisitions. In January 1965, B sells one of the debt obligations to a U.S. person. B cannot give a certificate of American ownership to the purchaser. The U.S. person who acquires the debt obligation of N from B is subject to the provisions of chapter 41 to the same extent as if B were a foreign person.

SECTION 4915. EXCLUSION FOR DIRECT INVESTMENTS

(a) *In general.*—Section 4915(a) provides that the tax imposed by section 4911 does not apply to the acquisition of stock or a debt obligation of a foreign corporation or foreign partnership where the acquiring person is investing in a foreign corporation or foreign partnership in which he has a substantial ownership interest.

Excluded acquisitions

Paragraph (1) of section 4915(a) states the general rule that an acquisition by a U.S. person of stock or debt obligations of a foreign corporation or foreign partnership is not subject to the interest equalization tax if immediately after the acquisition such person (or one or more includible corporations in an affiliated group, as defined in sec. 1504 of the code, of which such person is a member) owns (directly or indirectly) 10 percent or more of the total combined voting power of all classes of stock of such foreign corporation, or if such person owns (directly or indirectly) 10 percent or more of the profits interest of such foreign partnership. (Under sec. 4920(a)(2), any interest of a partner in a partnership is included within the definition of the term "stock.") Stock owned, directly or indirectly, by or for a foreign corporation or foreign partnership is considered as being owned proportionately by its shareholders or partners. The exclusion for direct investments applies to acquisitions from the corporation or partnership or from third parties, and to contributions of capital to the foreign corporation or foreign partnership by a person holding at least 10 percent of the voting power of all classes of stock of the corporation, or at least 10 percent of the profits interest of the partnership, immediately after making such capital contribution.

The application of section 4915(a)(1) is illustrated by the following examples:

Example (1).—On March 31, 1964, A, a U.S. person, acquires 100 shares of the only class of stock of foreign corporation N from the corporation, which immediately thereafter has a total of 1,000 shares outstanding. A's acquisition of the 100 shares of N stock is excluded from tax as the acquisition of a direct investment.

Example (2).—The facts are the same as in example (1), except that later in 1964 A lends N $100,000, taking a 5-year promissory note

in return. A's acquisition of the indebtedness of N is excluded from tax as the acquisition of a direct investment.

Example (3).—The facts are the same as in example (1), except that later in 1964 A purchases from R, a nonresident alien, an additional 50 shares of the stock of N. A's acquisition of the 50 shares of stock of N is exempt from tax as the acquisition of a direct investment.

Example (4).—On April 15, 1964, A, a U.S. person, acquires a 10 percent interest in the profits of foreign partnership M. M acquires 100 percent of the voting stock of foreign corporation O. Subsequently, A lends O $100,000, taking a 5-year promissory note in return. A's acquisition of the indebtedness of O is excluded from tax as the acquisition of a direct investment since A is considered to own 10 percent of the stock of O.

Overpayment with respect to certain taxable acquisitions

Paragraph (2) of section 4915(a) provides that the tax paid on the acquisition of stock of a foreign corporation or foreign partnership by a U.S. person will constitute an overpayment if such person continuously holds such stock from the time of its acquisition to the last day of the calendar year in which the acquisition was made and as of such last day owns 10 percent or more of the total combined voting power of all classes of stock of the corporation or 10 percent or more of the profits interest of the partnership. Paragraph (2) further provides that under regulations prescribed by the Secretary of the Treasury or his delegate, credit or refund (without interest) will be allowed or made with respect to such overpayment. This provision permits a credit or refund on acquisitions of stock if the acquiring U.S. person is unable to meet the direct investment requirements of section 4915(a)(1) in a single acquisition but does meet such requirements through a series of acquisitions in the same year. The exclusion does not apply to the acquisition of a debt obligation by the U.S. person prior to his acquisition of the requisite 10-percent interest in a foreign corporation or foreign partnership.

The application of section 4915(a)(2) is illustrated by the following example:

Example.—On each of September 1, October 1, November 1, and December 1, 1964, A, a U.S. person, acquires from S, a foreign corporation, 2,500 shares of the only class of stock of foreign corporation N, which has a total of 100,000 shares outstanding. On September 15, 1964, A lends N $10,000, taking a 5-year promissory note in return. On December 15, 1964, A lends N an additional $10,000 on the same terms. On December 31, 1964, A holds all 10,000 shares of stock so acquired. A is entitled to a refund (without interest) of the tax paid on the acquisition made on September 1, and a credit (without interest) against the tax applicable to the acquisitions made on October 1 and November 1. The acquisition of stock made on December 1 is excluded from tax under section 4915(a)(1) as a direct investment. A incurs a tax of $435 (4.35 percent of $10,000) on the acquisition of the 5-year promissory note of N on September 15, 1964; but the acquisition of the similar debt obligation of N on December 15, 1964, is excluded from tax as a direct investment.

(*b*) *Special rule for Government-controlled enterprises.*—Section 4915 (b) provides that a U.S. person will be considered to meet the direct

investment ownership requirement of section 4915(a)(1) with respect to a foreign corporation or foreign partnership if (A) the government of a foreign country or any political subdivision thereof (or an agency or instrumentality of such a government), directly or indirectly, restricts to less than 10 percent the percentage of the total combined voting power of all classes of stock of such corporation or the percentage of the profits interest in such partnership which may be owned by such U.S. person; (B) such U.S. person owns at least 5 percent of the total combined voting power of so much of such stock, or at least 5 percent of so much of such profits interest, as is not owned by such foreign government, subdivision, agency, or instrumentality; (C) a trade or business actively conducted in one or more foreign countries by such U.S. person (or by one or more corporations in an affiliated group, as defined in sec. 48(c)(3)(C) of the code, of which such person is a member) is directly related to the business carried on by such foreign corportion or partnership; and (D) such person, and one or more other U.S. persons each of whom satisfies (B) and (C), together meet the 10 percent direct investment requirement.

The application of section 4915(b) is illustrated by the following example:

Example.—Corporation A, corporation B, and corporation C are U.S. corporations. Each has a wholly-owned foreign subsidiary which is actively engaged in selling petroleum products in foreign country M. Country M permits foreign corporation F to be formed to construct and operate an oil pipeline in country M. An agency of country M acquires 50 percent of the only class of stock of F, and the remaining 50 percent is allocated by country M among the oil companies doing business in that country. Under this allocation, A acquires 9 percent, B acquires 7 percent, and C acquires 3 percent of the stock of F (constituting 18, 14, and 6 percent, respectively, of the stock not owned by the agency of M). All three acquisitions are excluded from tax as direct investments.

(c) *Exception for foreign corporations or partnerships formed or availed of for tax avoidance.*—Section 4915(c) prevents the application of the exclusion for direct investments in certain cases.

In general

Paragraph (1) of section 4915(c) provides that the exclusion for direct investments under section 4915(a) does not apply if the foreign corporation or foreign partnership involved is formed or availed of by the U.S. person for the principal purpose of acquiring, through the foreign corporation or foreign partnership, an interest in stock or debt obligations the acquisition of which would, if made directly by the U.S. person, be subject to the interest equalization tax.

Thus, if A, a U.S. person, acquires 10 percent of the stock of N, a foreign corporation engaged primarily in the business of investing, reinvesting, or trading in foreign securities the direct acquisition of which by A would be subject to interest equalization tax, the acquisition is not excluded under section 4915. Moreover, even if M is not engaged in such activity at the time of the acquisition by A, the acquisition would not be excluded under such section if M is later availed of by A (prior to the termination of the tax) principally for the purpose of acquiring for A an interest in a portfolio of foreign securities. On the other hand, if M actively engages in the conduct of a business other than a securities business and acquires debt obligations as an

incident of such business, it is not considered to be availed of for the proscribed purpose.

Commercial banks, underwriters, and required holdings

Paragraph (2) of section 4915(c) provides that the "formed or availed of" exception to the exclusion from tax for direct investments in foreign corporations and foreign partnerships is not operative in cases where the foreign corporation or partnership is principally acquiring foreign stock or debt obligations because of legal requirements imposed as a condition to doing business in a foreign country or, in the case of a foreign corporation or partnership engaged in business as an underwriter (within the meaning of sec. 4919(c)(1)) or in the business of commercial banking, where transactions are made in the ordinary course of such business.

Thus, the fact that a U.S. person acquires stock or debt obligations of a foreign corporation or partnership which in turn acquires stock and debt obligations of other foreign issuers and obligors—

(A) in making loans in the ordinary course of its business as a commercial bank,

(B) in the ordinary course of its business of underwriting and distributing securities issued by other persons, or

(C) to satisfy minimum requirements relating to holdings of stock or debt obligations of foreign issuers or obligors imposed by the laws of foreign countries where such foreign corporation or partnership is doing business,

will not, standing alone, be considered an acquisition of an interest in stock or debt obligations of foreign issuers or obligors by the U.S. person for purposes of the exclusion under section 4915.

Loss of entitlement to exclusion or refund where foreign corporation or partnership is availed of for tax avoidance

Paragraph (3) of section 4915(c) provides that where an acquisition is excluded from tax as a direct investment under section 4915(a)(1), or a credit or refund of tax has been received under section 4915(a)(2) with respect to acquisitions made during a calendar year, but the foreign corporation or foreign partnership is availed of by the acquiring person (after the acquisition or calendar year involved but before the termination of the tax) for the principal purpose of tax avoidance as described in paragraph (1) of such section, such person will incur liability for the tax under section 4911 at the time the foreign corporation or partnership is availed of for such purpose; and the amount of such tax will be equal to the amount of the tax which would have applied under section 4911 if the direct investment had not previously been excluded, or (in a case involving a credit or refund under sec. 4915(a)(2)) to the aggregate amount of tax for which such person was liable under section 4911 upon his acquisitions of the stock or debt obligations involved.

(*d*) *Exception for acquisitions made with intent to sell to U.S. persons.*—Section 4915(d) provides that the direct investments exclusion is inapplicable if stock or debt obligations of a foreign issuer or obligor are acquired by a U.S. person with an intent to sell, or to offer to sell, any part thereof to U.S. persons. Thus, if a U.S. underwriter acquires 10 percent or more of the stock of a foreign corporation with a view to the distribution of any part of such stock to U.S. persons through resale, the acquisition is not excludable under section

4915(a). (However, if all or part of the stock acquired is sold to persons other than U.S. persons, a credit or refund of the interest equalization tax imposed may be allowed with respect to these sales under sec. 4919.) On the other hand, if a domestic corporation, solely to carry out a plan for expanding its markets abroad, acquires 10 percent or more of the stock of a foreign corporation but later, for sound business reasons, disposes of its interest to a U.S. person, such acquisition will not be considered to have been made with an intent to sell, or to offer to sell, such stock to U.S. persons, and it will be excluded under section 4915 from the tax.

SECTION 4916. EXCLUSION FOR INVESTMENTS IN LESS DEVELOPED COUNTRIES

(a) *General rule.*—Section 4916(a) provides an exclusion from the interest equalization tax for investments by U.S. persons (in stock or debt obligations of foreign issuers or obligors) which constitute investments in a less developed country. These investments are—

(1) a debt obligation issued or guaranteed by the government of a less developed country, by a political subdivision of such a country, or by an agency or instrumentality of such a government;

(2) stock or a debt obligation of a less developed country corporation; and

(3) a debt obligation issued by an individual or partnership resident in a less developed country in return for property which is used, consumed, or disposed of wholly within one or more less developed countries.

A debt obligation otherwise qualifying for this exclusion will not be disqualified because it is guaranteed by a person other than one described in section 4916(a) or because it is repayable in the currency of a country which is not considered less developed.

(b) *Less developed country defined.*—Section 4916(b) defines the term "less developed country." Except for certain countries and areas (specified in such section) which may not be designated as less developed countries, the designation of countries to be considered economically less developed for this purpose is left to Executive order. For the interim period prior to the issuance of an Executive order under the new chapter 41, all countries designated as less developed (under sec. 955(c)(3) of the code) by Executive Order No. 11071, dated December 27, 1962 (designating certain areas as economically less developed countries for purposes of subpts. A and F of pt. III of subch. N, and sec. 1248 of ch. 1 of the code), will be considered to be less developed for purposes of the interest equalization tax. This includes all countries, and overseas territories, departments, provinces, and possessions of countries (other than areas within the Sino-Soviet bloc), except those specified. The countries designated as less developed for purposes of section 4916 need not (except for the interim period referred to above) be the same as those designated as less developed in any Executive order under section 955(c)(3) of the code. The designation of a country as a less developed country under section 4916 can be terminated (after such interim period) only by a further Executive order after 30 days' notice to the Congress. Any such termination will not affect the treatment of acquisitions occurring prior to the issuance of the terminating Executive order.

(c) *Less developed country corporation defined.*—Section 4916(c) defines the term "less developed country corporation."

In general

Paragraph (1) of section 4916(c) defines a less developed country corporation as one which (for the applicable periods described in par. (2)) (A) meets the requirements of section 955(c) (1) or (2) of the code; or (B) has gross income 80 percent or more of which is derived from sources within less developed countries, and assets 80 percent or more in value of which consists of property described in clauses (iii), (iv), and (v) of section 955(c)(1)(B) of the code. For this purpose, the determination of whether a foreign country is a less developed country is to be made in accordance with section 4916(b).

Section 955(c)(1) of the code provides that a corporation will qualify as a less developed country corporation if it conducts one or more active trades or businesses in one or more less developed countries, derives 80 percent or more of its gross income from less developed countries, and has 80 percent or more in value of its assets consisting of—

(A) property used in such trades or businesses and located in less developed countries;

(B) money and deposits with persons carrying on the banking business;

(C) stock, and obligations which at the time of their acquisition have at least a 1-year maturity, of any other less developed country corporation;

(D) obligations of a less developed country;

(E) investments required because of restrictions imposed by a less developed country; and

(F) property described in section 956(b)(2) of the code, relating to exceptions from the term "United States property."

For purposes of section 955(c)(1), whether income is derived from sources within less developed countries is determined under regulations prescribed by the Secretary of the Treasury or his delegate.

Section 955(c)(2) of the code provides that the term "less developed country corporation" also includes a foreign corporation 80 percent or more of the assets of which consists of assets used, or held for use, for or in connection with production of income described below and property described in section 956(b)(2), relating to exceptions from the term "United States property", and 80 percent or more of the gross income of which consists of—

(A) gross income derived from, or in connection with, the using (or hiring or leasing for use) in foreign commerce of aircraft or vessels registered under the laws of a less developed country, or from, or in connection with, the performance of services directly related to use of such aircraft or vessels, or from the sale or exchange of such aircraft or vessels, and

(B) dividends and interest received from foreign corporations which are less developed country corporations within the meaning of such section 955(c)(2) and 10 percent or more of the total combined voting power of all classes of stock of which is owned by the foreign corporation, and gain from the sale or exchange of stock or obligations of foreign corporations which are such less developed country corporations.

Under paragraph (1)(B) of the new section 4916(c), a foreign corporation will be regarded as a less developed country corporation even if it is not engaged in the active conduct of one or more trades or businesses in less developed countries, if it has 80 percent or more of its income from sources within less developed countries and has 80 percent or more in value of its assets in—

(A) stock, and debt obligations which at the time of their acquisition have at least a 1-year maturity, of any less developed country corporation;

(B) obligations of a less developed country; and

(C) investments which are required because of restrictions imposed by a less developed country.

For purposes of paragraph (1)(B) of section 4916(c), whether income is derived from sources within less developed countries is to be determined under the same rules as those applicable under section 955(c)(1) of the code.

Applicable periods

Paragraph (2) of section 4916(c) sets forth the applicable periods for which a corporation must meet the requirements contained in paragraph (1) of such section in order to qualify as a less developed country corporation. These periods are

(A) the annual accounting period of the foreign corporation immediately preceding the one in which the acquisition involved is made, if it had such an accounting period;

(B) the annual accounting period in which the acquisition is made; and

(C) the next succeeding annual accounting period.

If an acquisition is made in the first annual accounting period of a newly-formed foreign corporation, the acquisition will be excluded from the tax if the foreign corporation meets the applicable requirements for that accounting period and the next succeeding accounting period. If an acquisition is made in the final accounting period of a foreign corporation, the acquisition will not be excluded, unless the special rules of section 4916(c)(3) are applicable.

Special rules for treatment of corporations as less developed country corporations

Paragraph (3) of section 4916(c) provides that a foreign corporation will be deemed to be a less developed country corporation with respect to any acquisition if it is established to the satisfaction of the Secretary of the Treasury or his delegate before the acquisition occurs (or, in the case of an acquisition occurring before or within 60 days after the date of the enactment of the bill, pursuant to application made within such period following enactment as may be prescribed by the Secretary of the Treasury or his delegate in regulations) that the foreign corporation met the applicable requirements of section 4916(c)(1) for the annual accounting period (if any) immediately preceding the accounting period in which the acquisition is made, and may reasonably be expected to satisfy such requirements for the annual accounting period in which the acquisition is made and the next succeeding annual accounting period. In the case of an acquisition occurring on or before December 10, 1963, a foreign corporation will be treated as a less developed country corporation if the requirements of section 4916(c)(1) are met for the annual accounting period

immediately preceding the annual accounting period in which the acquisition occurred.

The elective ruling procedure provided for in section 4916(c)(3) is available for both new and outstanding issues. A ruling may be issued even if the foreign corporation is newly organized and has had no accounting period referred to in section 4916(c)(2)(A). A ruling may not be issued, however, if the foreign corporation had an accounting period referred to in section 4916(c)(2)(A) but did not qualify as a less developed country corporation for such period. If a ruling is issued by the Secretary of the Treasury or his delegate under section 4916(c)(3), the foreign corporation's subsequent failure to meet the requirements of section 4916(c)(1) for the annual accounting period in which the acquisition is made or the next succeeding annual accounting period will not result in loss of the exclusion.

Treatment of corporations as less developed country corporations in other cases

Paragraph (4) of section 4916(c) permits a U.S. person to treat a foreign corporation as a less developed country corporation for purposes of section 4916, even though no ruling under section 4916(c)(3) has been obtained, if such corporation has met the applicable requirements of section 4916(c)(1) for the annual accounting period (if any) immediately preceding the accounting period in which the acquisition involved is made and such person reasonably believes that such corporation will satisfy such requirements for the current and next succeeding annual accounting periods; but a person relying upon this paragraph is subject to possible subsequent liability for tax as provided in section 4916(d)(1).

(*d*) *Subsequent liability for tax in certain cases.*—Section 4916(d) provides in effect for the loss of exclusions previously allowed under section 4916(a) upon the happening of certain subsequent events.

Stock and debt obligations of certain corporations

Paragraph (1) of section 4916(d) provides that if a ruling is not obtained from the Secretary of the Treasury or his delegate with respect to an acquisition of stock or a debt obligation of a foreign corporation under section 4916(c)(3), and such corporation is treated under section 4916(c)(4) as meeting the applicable requirements of section 4916(c)(1) but fails to meet such requirements either for the annual accounting period in which the acquisition involved is made or for the next succeeding annual accounting period, the U.S. person making the acquisition involved will incur liability for the interest equalization tax on the last day of the accounting period of the foreign corporation with respect to which such failure occurs (prior to termination of the tax), in an amount equal to the tax which would have been payable under section 4911 if the exclusion had not applied at the time of the acquisition. This rule is illustrated by the following example:

Example.—On April 1, 1964, A, a U.S. person, acquires for $10,000 from B, a nonresident alien, bonds of foreign corporation M maturing on June 30, 1967. The annual accounting period of M immediately preceding the acquisition ends on December 31, 1963, and for that period M satisfies the requirements set forth in section 4916(c)(1). M fails to satisfy these requirements for its annual accounting period ending December 31, 1964. A ruling has not been obtained from the

Secretary of the Treasury or his delegate with respect to M under section 4916(c)(3). A incurs liability for the tax on December 31, 1964 (although the period remaining to maturity of the bonds at that time is less than 3 years), and the amount of the tax, computed on the basis of the period remaining to maturity of the bonds on April 1, 1964, is equal to 2.75 percent of $10,000, or $275.

Debt obligations issued in return for certain property

Paragraph (2) of section 4916(d) provides that if an exclusion is allowed under section 4916(a)(3) with respect to the acquisition of a debt obligation issued in return for property described in such section, but part or all of such property is used, consumed, or disposed of (before the termination of the tax) otherwise than wholly within one or more less developed countries, the acquiring person will incur liability for the tax under section 4911 as of the time the property is first so used, consumed, or disposed of, in an amount equal to the tax which would have been payable under section 4911 if the exclusion had not applied at the time of the acquisition.

SECTION 4917. EXCLUSION FOR ORIGINAL OR NEW ISSUES WHERE REQUIRED FOR INTERNATIONAL MONETARY STABILITY

(*a*) *In general.*—Section 4917(a) provides that the interest equalization tax will not be applicable to certain acquisitions which may be covered by an Executive order issued by the President. If the President determines that the application of this tax will have such consequences for a foreign country as to imperil or threaten to imperil the stability of the international monetary system, he may by such an Executive order exclude from the tax acquisitions of stock or debt obligations of the government of the foreign country or a political subdivision thereof, any agency or instrumentality of such a government, any corporation, partnership, or trust (other than a company registered under the Investment Company Act of 1940) organized under its laws, or any individual resident therein, including acquisitions of debt obligations secured by mortgages. The order will in any event be applicable only to acquisitions made as part of an original or new issue of stock or debt obligations as to which notice of acquisition is filed in accordance with regulations prescribed by the Secretary of the Treasury or his delegate. In the case of acquisitions made during the period from July 19, 1963, through the date of the enactment of the bill, notice of acquisition may be filed within such period following such date of enactment as is prescribed in regulations by the Secretary of the Treasury or his delegate.

The regulations under this section may permit or require filing of the prescribed notice to be made either before or after the acquisition occurs. Such notice may be required to set forth all the principal terms of the transaction involved and such other information as may be prescribed in such regulations.

It is contemplated that the regulations will not permit the filing of a notice of acquisition in connection with a private placement until the material terms of the transaction are agreed upon by the parties, or in connection with a public offering which is registered with the Securities and Exchange Commission until a registration statement has been filed with the Commission.

(b) *Applicability of Executive order.*—Section 4917(b) provides that an Executive order described in section 4917(a) may be applicable to all such original or new issues, or only to an aggregate amount or classification thereof, as stated in the order. If the order is applicable to a limited aggregate amount of such issues it will apply under regulations prescribed by the Secretary of the Treasury or his delegate to those acquisitions as to which notice of acquisition was first filed, provided in any given case that the acquisition described in the notice is made before or within 90 days after the date of filing. If the acquisition is not made within this period, the notice will have no effect. If a new notice is filed upon expiration of the 90-day period, the date on which this notice is filed will govern the applicability of the order to the acquisition. An Executive order described in section 4917(a) may be terminated in whole or in part at any time by an Executive order issued for that purpose, and the termination will be effective from the date the order is issued or from such later date as is specified in such order.

(c) *Original or new issue.*—Section 4917(c) provides (for purposes of sec. 4917) that a debt obligation is treated as part of an original or new issue only if acquired not later than 60 days after the date on which interest begins to accrue on such obligation, and that stock is treated as part of an original or new issue only when it is acquired from the issuer by the U.S. person claiming the exclusion. Stock is considered an original or new issue only if it is previously unissued; treasury stock will not be so considered. A debt obligation may be acquired from a person other than the obligor within the 60-day period and still be regarded as part of an original or new issue.

SECTION 4918. EXEMPTION FOR PRIOR AMERICAN OWNERSHIP

(a) *General rule.*—Section 4918(a) states the general rule that the interest equalization tax is inapplicable to an acquisition of stock or a debt obligation of a foreign issuer or obligor if it is established by clear and convincing evidence that the person from whom such stock or debt obligation was acquired was a U.S. person throughout the period of his ownership or continuously since July 18, 1963. The effect of this exemption for prior American ownership is to assure that only one tax will be paid on stock or debt obligations acquired after July 18, 1963, and that no tax will be paid on those acquired prior to that date, so long as continuous American ownership is maintained. A person who has not maintained his status as a U.S. person during the entire period of his ownership of stock or a debt obligation (or continuously since July 18, 1963) will not be permitted to transfer it free of the tax to other Americans.

Under section 4914(g)(2), neither a person making an acquisition excluded from the tax under section 4914(b)(3) nor an insurance company acquiring stock or a debt obligation which it designates (or is required to designate) under section 4914(e) is considered a U.S. person for purposes of section 4918 with respect to the stock or debt obligation so acquired. Section 4920(a)(4)(C) provides that an investment company which has elected under section 4920(a)(3)(B) to be treated as a foreign issuer or obligor is not considered a U.S. person. While one or more classes of a foreign corporation's stock may be treated under section 4920(a)(3) as not being the stock of a foreign

issuer, the foreign corporation is not considered a U.S. person for any of the purposes of chapter 41.

The clear and convincing evidence required by section 4918(a) may be supplied through certificates of American ownership as described in section 4918(b), or through the use of individual or blanket certificates of American ownership and the furnishing of confirmations by members of national securities exchanges and national securities associations in accordance with the requirements described in section 4918 (c) and (d).

(*b*) *Certificate of American ownership.*—Section 4918(b) provides that, for purposes of the exemption under section 4918(a), a certificate of American ownership executed and filed as provided in section 4918(e), and received in connection with an acquisition, is conclusive proof of prior American ownership unless the person making such acquisition has actual knowledge that the certificate is false in any material respect.

(*c*) *Trading on certain national securities exchanges.*—Section 4918(c) provides that, for purposes of the exemption under section 4918(a), a written confirmation received from a member or member firm of a registered national securities exchange stating that an acquisition was made in the regular market on the exchange and not subject to a special contract will be conclusive proof of prior American ownership (unless the acquiring person has actual knowledge that the confirmation is false in any material respect) if the exchange has in effect at the time of the acquisition rules providing in substance that (A) a member or member firm can effect a sale as broker (of stock or debt obligations subject to the tax) in the regular market on the exchange only if the member or member firm has in his or its possession a certificate of American ownership with respect to the stock or debt obligation sold or a blanket certificate of American ownership with respect to the seller's account, and (B) a member or member firm effecting a purchase as broker of such stock or debt obligations other than in the regular market and subject to a special contract must furnish the acquiring person a written confirmation stating that the acquisition was made subject to such special contract. A written confirmation furnished to a custodian, nominee, or agent acting for the purchaser is deemed to have been furnished to the purchaser.

In cases where stock or a debt obligation subject to tax under chapter 41 is traded on an exchange having the rules described above, a U.S. person selling such stock or debt obligation executes and files with the member or member firm acting as his broker either an individual or blanket certificate of American ownership. The member or member firm, not having actual knowledge that the certificate is false in any material respect, may effect the sale in the regular market on the exchange and the member or member firm acting on behalf of the buyer can assume the seller is a U.S. person since the transaction occurred in the regular market. The buyer will receive a confirmation from the member or member firm effecting the purchase on his behalf stating that the acquisition was made in the regular market and not subject to a special contract. This confirmation is regarded for purposes of this exemption as conclusive proof of prior American ownership.

If the seller is not a U.S. person entitled to furnish an individual or blanket certificate of American ownership, the member or member

firm acting on his behalf may not effect the sale in the regular market on the exchange and must make the sale subject to a special contract. In such a case, the member or member firm acting on behalf of the buyer must furnish the buyer a written confirmation stating that the acquisition was made subject to such special contract, and, of course, such confirmation is not regarded as proof of prior American ownership.

(*d*) *Trading in the over-the-counter market.*—Section 4918(d) provides that, for purposes of the exemption under section 4918(a), a written confirmation received from a member or member firm of a registered national securities association in connection with an acquisition made in the U.S. over-the-counter market is regarded as conclusive proof of prior American ownership, unless the confirmation states that the acquisition was made from a person who has not executed and filed a certificate of American ownership with respect to the stock or debt obligation sold or a blanket certificate of American ownership with respect to the seller's account (or the acquiring person has actual knowledge that the confirmation is false in any material respect), if the association has in effect at the time of the acquisition rules providing in substance that a member or member firm effecting a sale as broker, in the over-the-counter market, of any stock or debt obligation subject to the tax but for this exemption, must (A) have an individual or blanket certificate in his possession, or (B) furnish the person acquiring such stock or debt obligation a written confirmation stating that the acquisition was made from a person who has not executed and filed such a certificate. A written confirmation furnished to a custodian, nominee, or agent acting for the purchaser is deemed to have been furnished to the purchaser. Section 4918(d) also provides that a member or member firm who makes an acquisition for his or its own account in the over-the-counter market may treat a blanket certificate of American ownership with respect to the seller's account as conclusive proof for purposes of this exemption of prior American ownership unless such member or member firm has actual knowledge that the certificate is false in any material respect.

In cases where stock or a debt obligation subject to tax under chapter 41 is sold in the over-the-counter market and a member or member firm of the National Association of Securities Dealers (if such association has adopted rules as described in sec. 4918(d)) is acting as broker for the seller or acquiring for his or its own account, the U.S. person selling such stock or debt obligation executes and files with the member or member firm either an individual or blanket certificate of American ownership. Unless such member or member firm has actual knowledge that the certificate is false in any material respect, a written confirmation can be furnished by the member or member firm which does not specify whether or not the seller executed and filed a certificate. Such a confirmation is regarded for purposes of this section as conclusive proof of prior American ownership. If the seller is not a U.S. person entitled to furnish an individual or blanket certificate of American ownership, the member or member firm acting as broker on his behalf must furnish the acquiring person a written confirmation stating that the acquisition was made from a person who has not executed and filed an individual or blanket certificate of American ownership, and, of course, such confirmation is not regarded as proof of prior American ownership.

(*e*) *Execution, filing, and contents of certificate.*—Section 4918(e) provides that a certificate of American ownership or a blanket certifi-

cate of American ownership under section 4918 must be executed and filed in such manner and set forth such information as the Secretary of the Treasury or his delegate prescribes by regulations. It is contemplated that such regulations will provide, among other things, in connection with certificates of American ownership, that such a certificate may be executed either by a former owner or by a U.S. person acting as the nominee of the former owner and that the signature must be guaranteed by a U.S. bank, a member of the National Association of Securities Dealers, or a member firm of a national securities exchange registered with the Securities and Exchange Commission. Where the certificate is executed by a nominee, it will not be necessary to reveal the name of the actual owner to the purchaser; but the nominee will be required to maintain adequate records to identify the U.S. person for whose account the securities were held and to establish such owner's U.S. citizenship, residence, or incorporation during his period of ownership. With respect to blanket certificates of American ownership, the regulations are expected to provide that the owner of an account must certify that he is the actual owner of all securities sold through the account and that he has been a U.S. person continuously since July 18, 1963. If such person ceases to be a U.S. person, he will be required to certify that he will notify the member or member firm of the change and will make no sale through the account until such notice has been received. Blanket certificates of American ownership will be permitted to be executed by nominees subject to requirements such as those described for individua lcertificates of American ownership.

SECTION 4919. SALES BY UNDERWRITERS AND DEALERS TO FOREIGN PERSONS

(a) *Credit or refund.*—Section 4919(a) provides that a credit against, or refund of, the tax paid under section 4911 upon the acquisition of stock or debt obligations of a foreign issuer or obligor may be allowed or made if the stock or debt obligations (1) are acquired by an underwriter from the foreign issuer or obligor (or from a person or persons controlling, controlled by, or under common control with such issuer or obligor) and are resold directly to persons other than U.S. persons in connection with a private placement, (2) are acquired by an underwriter in connection with a public offering by a foreign issuer or obligor (or by a person or persons controlling, controlled by, or under common control with such issuer or obligor) and are resold to persons other than U.S. persons, or (3) consist of debt obligations acquired by a dealer in the ordinary course of his business from persons other than U.S. persons and resold to persons other than U.S. persons within 90 days after (or, in the case of short sales, within 90 days before) their acquisition. Control with respect to an issuer or obligor has the same meaning for these purposes (and for purposes of the definition in sec. 4919(c)(1)) as under the Securities Act of 1933.

For purposes of section 4919(a) it is immaterial whether the acquisition or resale by the underwriter or dealer takes place in the United States. The tax paid with respect to any such acquisition will constitute an overpayment of tax only if it is clearly established that the stock or debt obligations involved were resold to persons other than U.S. persons. Where stock or debt obligations are resold as part of a public offering, the underwriter may claim a credit or refund not

only for its own sales to persons other than U.S. persons but also for any such sales made by other U.S. persons participating in the distribution of the stock or debt obligations acquired by the underwriter.

The credit or refund (without interest) is to be allowed to an underwriter or dealer under regulations prescribed by the Secretary of the Treasury or his delegate. Where an acquisition by an underwriter is concerned, if the underwriter sells all or part of the stock or debt obligations acquired to persons other than U.S. persons during the same return period in which the acquisition of such stock or debt obligations is made, the acquisition will be subject to the tax imposed by section 4911 and an offsetting tax credit for such sales will be allowed under section 4919. If the sales by the underwriter to persons other than U.S. persons occur in a return period subsequent to the return period in which the acquisition by the underwriter is made, the tax imposed by section 4911 on the acquisition will be paid with the interest equalization tax return filed for the prior period and a credit or refund of tax will be allowed or made under section 4919 upon the filing of a claim therefor. It is contemplated that a tax credit may also be allowed to the underwriter, if claimed, for sales to persons other than U.S. persons which take place after the reporting period during which the acquisition occurred but before the return for that period is due. The credit or refund arising from the resale of debt obligations by dealers will be claimed and allowed in a similar manner.

(b) *Evidence to support credit or refund.*—Section 4919(b) provides that an underwriter or dealer claiming a credit or refund under such section with respect to the interest equalization tax must file with the return required under section 6011(d) of the code such information pertaining to his claim for credit or refund as the Secretary of the Treasury or his delegate may prescribe by regulations. It is contemplated that the type of information required from an underwriter with respect to a private placement or public offering may include the following:

(A) The name and address of the foreign issuer or obligor (or the person or persons related in control) whose stock or debt obligations were acquired and the date of acquisition;

(B) The consideration paid or to be paid by the underwriter for the stock or debt obligations acquired;

(C) The total number of shares of stock or the total face amount of debt obligations acquired and a brief description thereof; and

(D) (i) In the case of private placements: The total sold; the total sold directly by the underwriter to persons other than U.S. persons; the dates of sale and the names and addresses of the persons to whom sold; and a copy or description of any agreement or agreements governing the acquisition or sale of the stock or debt obligations by the underwriter; or

(ii) In the case of public offerings: The total sold; the total sold to persons other than U.S. persons; the total sold by U.S. persons participating in the distribution; and a copy of any prospectus or offering circular used in effectuating any of the sales.

It is contemplated that the type of information required from a dealer claiming the credit or refund may include a description of the debt obligations involved, the names and addresses of the persons to whom they were sold, and the date or dates of sale.

The claim for credit or refund by an underwriter will not be allowed with respect to stock or debt obligations sold by a U.S. person (other than the underwriter) participating, in connection with a public offering, in the distribution of the stock or debt obligations acquired by the underwriter unless the underwriter establishes by clear and convincing evidence that the stock or debt obligations were sold to persons other than U.S. persons. A certificate of sales to foreign persons executed by a U.S. person (other than the underwriter) and relied upon by the underwriter will be regarded as conclusive proof that the sales were made to foreign persons unless the underwriter has actual knowledge that the certificate is false in any material respect. The requirements for filing such a certificate, the information to be set forth therein, and the manner in which it is to be executed will be prescribed by the Secretary of the Treasury or his delegate by regulations.

In any case where two or more underwriters form a group for the purpose of purchasing and distributing (through resale) stock or debt obligations of a single foreign issuer or obligor, the filing of a certificate of sales to foreign persons by any one of such underwriters may, to the extent provided by regulations prescribed by the Secretary of the Treasury or his delegate, constitute the filing of such certificate on behalf of all of such underwriters. Normally, in such cases all certificates of sales to foreign persons would be permitted to be filed with the interest equalization tax return filed by the managing underwriter of the purchasing and selling group.

(c) *Definitions.*—Paragraph (1) of section 4919(c) defines the term "underwriter" to mean any person who has purchased stock or debt obligations from the issuer or obligor thereof (or from a person controlling, controlled by, or under common control with such issuer or obligor), or from another underwriter, with a view to the distribution through resale of such stock or debt obligations. Paragraph (2) defines a "dealer" as any person who is a member of the National Association of Securities Dealers and who is regularly engaged, as a merchant, in purchasing stock or debt obligations and selling them to customers with a view to the gains and profits which may be derived therefrom.

SECTION 4920. DEFINITIONS

(a) *In general.*—Section 4920(a) contains definitions of basic terms used in chapter 41.

Debt obligation

Paragraph (1) of section 4920(a) provides that, in general, the term "debt obligation" means any indebtedness, whether or not represented by a bond, debenture, note, certificate, or other writing, and whether or not bearing interest. The term also means any interest in, or any option or similar right to acquire, a debt obligation described in the preceding sentence, whether or not such interest, option, or right is in writing. It does not refer to the obligations (other than obligations to pay) of parties to executory contracts nor does it refer to the obligation of an insurer to pay under a contract of insurance or an annuity contract.

The term "debt obligation" does not include any obligation which—

(A) is convertible by its terms into stock of the obligor, if it is so convertible only within a period of 5 years or less from the date on which interest begins to accrue thereon; or

(B) arises out of the divorce, separate maintenance, or support of an individual who is a U.S. person.

Stock

Paragraph (2) of section 4920(a) provides that the term "stock" means any stock, share, or other capital interest in a corporation; any interest of a partner (whether general or limited) in a partnership; any interest in an investment trust; any indebtedness which is convertible by its terms into stock of the obligor if it is so convertible only within a period of 5 years or less from the date on which interest begins to accrue; and any interest in, or option or similar right to acquire, any of the interests described in this sentence.

Foreign issuer or obligor

Paragraph (3) of section 4920(a) defines the terms "foreign issuer," "foreign obligor," and "foreign issuer or obligor."

Under paragraph (3)(A) such terms mean any issuer of stock or obligor of a debt obligation which is an international organization of which the United States is not a member; the government of a foreign country or a political subdivision thereof, or an agency or instrumentality of such a government; a corporation, partnership, or estate or trust which is not a U.S. person as defined in paragraph (4); or a nonresident alien individual.

Paragraph (3)(B) provides that such terms also include a domestic corporation which, as of July 18, 1963, was a management company registered under the Investment Company Act of 1940 if (i) at least 80 percent of the value of the stock and debt obligations owned by the corporation on July 18, 1963, and at the end of every calendar quarter thereafter consists of stock or debt obligations of foreign issuers or obligors and of other debt obligations having an original period to maturity of 90 days or less; (ii) the corporation elects to be treated as a foreign issuer or obligor for purposes of chapter 41; and (iii) during the period from July 18, 1963, to the date the election is made the corporation does not materially increase its assets by borrowing or by issuing or selling its stock (other than stock issued or sold on or before September 16, 1963, as part of a public offering with respect to which a registration statement was first filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days prior thereto). The election must be made on or before the 60th day after the date of the enactment of the bill and must be made under regulations prescribed by the Secretary of the Treasury or his delegate. The election will be effective as of the date specified by the corporation, which may be before the date of the enactment of the bill but not later than the date on which the election is made. Such an election remains in effect until revoked. If, at the close of any succeeding calendar quarter, the company ceases to meet the 80-percent requirement described above, the election is deemed revoked as of the close of that quarter. If an election is revoked, no further election is permitted. In general, the effect of this provision is to permit a management company which elects to be treated as a foreign issuer or

obligor to manage its portfolio of foreign securities without incurring the interest equalization tax which would normally be incurred on acquisitions of such foreign securities. In addition, the provision has the effect of imposing the interest equalization tax on the acquisition by a U.S. person of any shares of the company which are newly issued or not owned by U.S. persons prior to acquisition.

If the assets of a foreign corporation are acquired by a domestic corporation in a reorganization described in subparagraph (D) or (F) of section 368(a)(1) of the code, both corporations are considered a single domestic corporation for purposes of section 4920(a)(3)(B). The election provided by section 4920(a)(3)(B) may be made by the foreign corporation in anticipation of its becoming a domestic corporation for these purposes.

Paragraph (3) of section 4920(a) also provides that a foreign corporation other than a company registered under the Investment Company Act of 1940 is not considered a foreign issuer with respect to any class of its stock which is traded on one or more national securities exchanges registered with the Securities and Exchange Commission, if the trading on such exchanges constituted the principal market for such class during the calendar year 1962 and more than 50 percent of such class was held of record by U.S. persons as of the latest record date before July 19, 1963. The latest date as of which record ownership of the stock of the foreign corporation was determined by the foreign corporation, whether for the declaration of dividends or other corporate purposes, governs. This provision has the effect of permitting U.S. persons to acquire free of the interest equalization tax a particular class of stock of a foreign issuer, the principal market for which is on such U.S. exchanges and more than 50 percent of which is owned of record by U.S. persons. The exclusion applies separately to each class of stock, but the acquisition need not be made on an exchange if the requirements of the provision have been satisfied.

A foreign corporation is not considered a U.S. person for purposes of chapter 41, even though this provision applies to one or more classes of its stock.

U.S. person

Paragraph (4) of section 4920(a) defines the term "U.S. person" to mean—

(A) a citizen or resident of the United States;

(B) a domestic partnership;

(C) a domestic corporation other than a corporation described in section 4920(a)(3)(B);

(D) an agency or wholly owned instrumentality of the United States;

(E) a State or political subdivision, or any agency or instrumentality thereof; and

(F) any estate or trust—

(i) the income of which from sources without the United States is includible in gross income under subtitle A of the code or would be so includible if not exempt from tax under section 501(a), 521(a), or 584(b) of the code; or

(ii) which is situated in the Commonwealth of Puerto Rico or a possession of the United States.

A foreign corporation engaged in trade or business within the United States is not regarded as a resident of the United States. The term "U.S. person" includes organizations exempt from Federal income tax

Domestic corporation; domestic partnership

Paragraph (5) of section 4920(a) defines the term "domestic corporation" to mean a corporation created or organized in the United States or under the laws of the United States or any State; the definition of "corporation" appearing in section 7701(a)(3) of the code is applicable to chapter 41. This paragraph also defines the term "domestic partnership" to mean a partnership created or organized in the United States or under the laws of the United States or any State; the definition of "partnership" appearing in section 7701(a)(2) of the code is applicable to chapter 41.

United States; State

Paragraph (6) of section 4920(a) provides that the term "United States" in a geographical sense includes the States, the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States; and the term "State" includes the District of Columbia, the Commonwealth of Puerto Rico, and the possessions of the United States. The term "possessions" includes the Virgin Islands and other territories of the United States.

Period remaining to maturity

Paragraph (7)(A) of section 4920(a) states the general rule that the period remaining to maturity of a debt obligation is the period beginning on the date of its acquisition and ending on the fixed or determinable date when, according to its terms, the payment of principal becomes due. For this purpose each installment of a debt obligation payable in installments is deemed to have a separate period remaining to maturity. (For the time when an acquisition is considered to be made, see sec. 4912(a) (discussed above).) This rule is illustrated by the following examples:

Example (1).—On May 31, 1964, A, a U.S. person, purchases from B, a nonresident alien, 20-year bonds of X, a foreign government. The bonds mature on December 31, 1974, and therefore have a remaining period to maturity of 10 years and 7 months.

Example (2).—On June 30, 1964, C, a U.S. person, acquires for $10,000 from D, a nonresident alien, a serial promissory note due in five equal annual installments of $2,000 commencing on August 1, 1966. The debt obligation has a period remaining to maturity of 2 years and 1 month with respect to $2,000, 3 years and 1 month with respect to $2,000, 4 years and 1 month with respect to $2,000, 5 years and 1 month with respect to $2,000, and 6 years and 1 month with respect to $2,000.

Paragraph (7)(B) of section 4920(a) sets forth in clauses (i) through (v) the modifications in the general rule which are to be made in determining the period remaining to maturity in certain special cases.

Clause (i) of paragraph (7)(B) provides that the period remaining to maturity of any interest in or option or similar right to acquire any debt obligation is the period remaining to maturity of the debt obligation at the time the interest, option, or right is acquired. This rule is illustrated by the following examples:

Example (1).—On July 31, 1964, A, a U.S. person, acquired from B, a nonresident alien, a depositary receipt which constitutes evidence of an interest in certain bonds of a foreign corporation which are held by a foreign bank and which mature on June 30, 1979. The depositary receipt has a period remaining to maturity of 14 years and 11 months.

Example (2).—On September 1, 1964, A, a U.S. person, acquires from M, a foreign corporation, an option to acquire 15-year bonds of M when such bonds are issued. The period remaining to maturity of the option is considered to be 15 years.

Clause (ii) of paragraph (7)(B) provides that the period remaining to maturity of any debt obligation which is renewable without affirmative action by the obligee, or of any interest in or option or similar right to acquire such a debt obligation, ends on the last day of the final renewal period. This rule is illustrated by the following example:

Example.—On June 1, 1964, A, a U.S. person, acquires from B, a nonresident alien, 20-year bonds of M, a foreign corporation. Such bonds are payable on December 31, 1974, except that, under the terms of the bonds, the obligation is automatically renewable for an additional period of 10 years if the holder does not demand payment within 30 days following the lapse of the initial term. The period to maturity is deemed to include the renewal period of 10 years.

Clause (iii) of paragraph (7)(B) provides that the period remaining to maturity of any debt obligation which has no fixed or determinable date when the payment of principal becomes due is considered to be 28½ years. This rule is illustrated by the following example:

Example.—On October 1, 1964, A, a U.S. person, acquires from B, a nonresident alien, bonds of F, a foreign government. The bonds are callable by the obligor at any time after 5 years; but they provide for payment of principal only upon such call or upon default by the issuer in payment of interest. The period remaining to maturity is deemed to be 28½ years.

Clause (iv) of paragraph (7)(B) provides that the period remaining to maturity of any debt obligation which is payable on the demand of the obligee is considered to be less than 3 years. This rule applies to a debt obligation as to which payment of principal is due or overdue at the time of its acquisition.

Clause (v) of paragraph (7)(B) provides that the period remaining to maturity of a debt obligation which is subject to retirement prior to its maturity through operation of a mandatory sinking fund will be determined under regulations prescribed by the Secretary of the Treasury or his delegate. It is contemplated that these regulations will generally determine the period remaining to maturity on the basis of the average life of the debt obligations involved.

(*b*) *Cross reference.*—Section 4920 (b) contains a cross reference to the definition of the term "acquisition" in section 4912.

SECTION 2. INTEREST EQUALIZATION TAX—Continued

(*b*) *Technical amendment.*—Subsection (b) of section 2 of the bill amends the table of chapters for subtitle D of the code to reflect the new chapter 41 (added by subsec. (a) of sec. 2 of the bill).

(c) *Effective date.*—Subsection (c) of section 2 of the bill contains the effective date provisions applicable to the new chapter 41.

General rule

Paragraph (1) of section 2(c) of the bill sets forth the general rule that, except as provided by paragraphs (2), (3), (4), (5), (6), and (7), the amendments made by section 2 apply only with respect to acquisitions of stock and debt obligations made after July 18, 1963.

Preexisting commitments

Paragraph (2) of section 2(c) of the bill provides that the interest equalization tax does not apply to an acquisition—

(A) made pursuant to an obligation to acquire stock or debt obligations which on July 18, 1963, was unconditional or was subject only to conditions contained in a formal contract under which partial performance had occurred;

(B) as to which on or before July 18, 1963, the acquiring U.S. person (or, in a case where two or more U.S. persons are acquiring as part of a single transaction, a majority in interest of such persons) had taken every action to signify approval under the procedures ordinarily employed by such person (or persons) in similar transactions and had sent or deposited for delivery to the foreign issuer or obligor written evidence of such approval in the form of a commitment letter or other signed document setting forth the principal terms of the acquisition, subject only to the execution of formal documents evidencing the acquisition and to customary closing conditions; or

(C) which would be excluded from tax under section 4915 (relating to direct investments) but for section 4915(c), if (i) on or before July 18, 1963, the acquiring person received from a foreign government (or an agency or instrumentality thereof) authorization to make the acquisition involved (and approval of the amount thereof), and (ii) such authorization was required in order for the acquisition to be made.

In order to qualify under the requirements of subparagraph (B) above, the acquiring U.S. person must have both approved the acquisition and sent or deposited the requisite commitment letter or similar document on or before July 18, 1963. If two or more U.S. persons are acquiring as part of a single transaction, those persons acquiring more than 50 percent of the actual value of the stock or debt obligations which are the subject of the transaction must have taken these actions on or before July 18, 1963. A person who had entered into a short sale contract on or before July 18, 1963, generally will be considered subject to a preexisting commitment because, in effect, such person is unconditionally obligated to make an acquisition to cover the short sale.

Public offering

Paragraph (3) of section 2(c) of the bill provides that the tax does not apply to an acquisition made on or before September 16, 1963, if—

(A) a registration statement (within the meaning of the Securities Act of 1933) was in effect with respect to the stock or debt obligation acquired at the time of its acquisition;

(B) the registration statement was first filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days prior thereto; and

(C) no amendment was filed with the Securities and Exchange Commission after July 18, 1963, and before the acquisition which had the effect of increasing the number of shares of stock or the aggregate face amount of the debt obligations covered by the registration statement.

Investment of proceeds of subscription offering

Paragraph (4) of section 2(c) of the bill provides that the tax does not apply to acquisitions of stock or debt obligations by a corporation electing to be treated as a foreign issuer or obligor under section 4920(a)(3)(B), to the extent that the amount of consideration paid for all such stock and debt obligations does not exceed the proceeds received by such corporation from a subscription offering, completed on or before September 16, 1963, as to which a registration statement was filed with the Securities and Exchange Commission on July 18, 1963, or within 90 days prior thereto.

Listed securities

Paragraph (5) of section 2(c) of the bill provides that the tax does not apply to an acquisition made on or before August 16, 1963, if the stock or debt obligation involved was acquired on a national securities exchange registered with the Securities and Exchange Commission. This provision applies to acquisitions made on such an exchange without regard to whether the acquired security is listed on the exchange, but it does not apply to acquisitions of listed securities which are not made through the exchange.

Options and foreclosures

Paragraph (6) of section 2(c) of the bill provides that the tax does not apply to an acquisition—

(A) of stock pursuant to the exercise of an option or similar right, or of a right to convert a debt obligation into stock of the same issuer, if such option or right was held on July 18, 1963, by the person making the acquisition or by a decedent from whom such person acquired the right to exercise such option or right by bequest or inheritance or by reason of such decedent's death; or

(B) of stock or debt obligations as a result of a foreclosure by a creditor pursuant to the terms of an instrument held by such creditor on July 18, 1963.

Domestication

Paragraph (7) of section 2(c) of the bill provides that the tax does not apply to the acquisition by a domestic corporation of the assets of a foreign corporation pursuant to a reorganization described in section 368(a)(1) (D) or (F) of the code if the acquisition occurs on or before the 180th day after the date of the enactment of the bill and the foreign corporation is a management company registered under the Investment Company Act of 1940 from July 18, 1963, until the time of the acquisition. The effect of this provision is to prevent foreign investment companies reincorporating as domestic investment companies from being subject to the interest equalization tax on the portfolio of foreign securities held at the time of reincorporation.

Meaning of terms

Paragraph (8) of section 2(c) of the bill provides that terms used in section 2(c) of the bill (except as specifically otherwise provided) have the same meaning as when used in the new chapter 41 of the code.

SECTION 3. RETURNS

(*a*) *Making of returns.*—Subsection (a) of section 3 of the bill amends section 6011 of the code (relating to general requirement of return, statement, or list) by redesignating subsection (d) as subsection (e) and by adding a new subsection (d).

SECTION 6011(d). INTEREST EQUALIZATION TAX RETURNS

In general

Paragraph (1) of section 6011(d) provides for the filing, on a calendar quarter basis, of returns of the interest equalization tax imposed by section 4911. A return must be filed by each person who incurs liability for the tax during the calendar quarter, and, in general, by each person who makes acquisitions during the calendar quarter which are nontaxable by reason of the exemption provided in section 4918 for stock or debt obligations acquired from a U.S. person. However, a return need not be filed in connection with an acquisition as to which a written confirmation, furnished in accordance with the requirements described in section 4918 (c) or (d), is treated as conclusive proof of American ownership, nor must such an acquisition be listed in any return made under this paragraph.

In the case of a person incurring liability for interest equalization tax, the return must disclose the taxable acquisitions and the amount of tax incurred, and must have attached a list of transactions during the quarter (other than acquisitions as to which written confirmations are furnished in accordance with the requirements described in sec. 4918 (c) or (d)) in respect of which no liability for payment of tax is incurred by reason of the provisions of section 4918. The list must be accompanied by clear and convincing evidence that these acquisitions are ones to which the provisions of section 4918 apply. A certificate of American ownership described in section 4918(e) will, of course, constitute clear and convincing evidence for this purpose.

In the case of a person who does not incur liability for the interest equalization tax during the calendar quarter but who makes acquisitions to which the provisions of section 4918 apply (other than acquisitions as to which written confirmations are furnished in accordance with the requirements described in sec. 4918 (c) or (d)), the return must have a list of such acquisitions attached and must be accompanied by the requisite evidence showing that the acquisitions are ones to which the provisions of section 4918 apply.

A person who receives a written confirmation in connection with an acquisition from a member or member firm of a national securities exchange or national securities association which is treated under the provisions of section 4918 (c) or (d) as conclusive proof of prior American ownership is not required to submit a return or accompanying evidence as to such acquisition. If such person is required to file a return because liability is incurred in connection with other transac-

tions, acquisitions as to which such a written confirmation is received need not be listed on the return.

Information returns of commercial banks

Paragraph (2) of section 6011(d) provides that every U.S. person which is a commercial bank must file a return with respect to loans and commitments to foreign obligors at such times, in such manner, and setting forth such information as the Secretary of the Treasury or his delegate may prescribe by forms and regulations. (Debt obligations acquired by a commercial bank in making loans in the ordinary course of its commercial banking business are excluded from the interest equalization tax under sec. 4914(b)(2)(A).) It is contemplated that returns may include (in addition to any information on aggregate lending activity) information concerning the purpose of each loan, the type of borrower, and the principal terms of the transaction.

Reporting requirements for members of exchanges and associations

Paragraph (3) of section 6011(d) provides that members and member firms of national securities exchanges and national securities associations which are registered with the Securities and Exchange Commission (and which have adopted rules of the type described in sec. 4918 (c) or (d)) must keep such records and file such information as the Secretary of the Treasury or his delegate may prescribe by regulations in connection with sales effected by such members and member firms as brokers, and acquisitions made for their own accounts, of stock or debt obligations as to which a certificate of American ownership or blanket certificate of American ownership is executed and filed as described in section 4918(e).

(*b*) *Time for filing returns.*—Subsection (b) of section 3 of the bill amends part V of subchapter A of chapter 61 of the code (relating to time for filing returns and other documents) by adding at the end thereof a new section 6076, which provides that each return of interest equalization tax must be filed on or before the last day of the first month following the period for which the return is made.

(*c*) *Publicity of returns.*—Subsection (c) of section 3 of the bill amends section 6103(a)(2) of the code (relating to public record and inspection) to provide in effect that interest equalization tax returns will be open to public examination and inspection only on the same basis as other returns.

(*d*) *Clerical amendment.*—Subsection (d) of section 3 of the bill amends the table of sections for part V of subchapter A of chapter 61 of the code to reflect the new section 6076 (added by subsec. (b) of sec. 3 of the bill).

(*e*) *First return period.*—Subsection (e) of section 3 of the bill contains one exception to the rule provided in section 6011(d) of the code (as added by subsec. (a) of sec. 3 of the bill) for the making of returns on a calendar-quarter basis. Under this exception the first period for which an interest equalization tax return is to be made is the period commencing July 19, 1963, and ending at the close of the calendar quarter in which the bill is enacted.

SECTION 4. DISALLOWANCE OF DEDUCTION FOR AMOUNT PAID AS INTEREST EQUALIZATION TAX

Section 4 of the bill adds to section 263(a) of the code (relating to capital expenditures) a new paragraph (3). The new paragraph would deny, for income tax purposes, any deduction for interest equalization tax paid by a person under section 4911 on his acquisitions of foreign stock and debt obligations, except to the extent that any amount attributable to the amount paid as such tax is included in gross income for the taxable year.

At the present time section 164(b)(3) of the code denies, for income tax purposes, a deduction for the amount of certain Federal excise taxes (which would include the new interest equalization tax), with a provision, however, that section 164(b)(3) will not prevent these taxes from being deducted under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income).

The effect of paragraph (3) of section 263(a), in generally denying a deduction for income tax purposes of interest equalization tax, is to require the acquiring person to capitalize the amount paid by him as interest equalization tax. If an amount paid by a U.S. person as interest equalization tax on the acquisition of a debt obligation, when added to the basis of such debt obligation, creates bond premium (as defined in sec. 171(b) of the code), such bond premium will be amortizable in accordance with section 171.

The exception provided from the general rule denying a deduction for income tax purposes of the interest equalization tax applies in a case where the interest equalization tax itself, or a portion thereof, is included in gross income. An illustration of this is a situation where a bond having a 30-year maturity is sold by a foreign underwriter for $1,000, on which an American purchaser must pay a tax of $150. At the time of his acquisition, the purchaser demands $150 from the underwriter as reimbursement for the tax which he must pay. If the purchaser accepts $100 in satisfaction of his demand, the $100 is included in the purchaser's gross income, and he will be allowed a deduction of $100 from gross income for the tax paid by him.

SECTION 5. PENALTIES

Section 5 of the bill adds to the code three new sections imposing civil and criminal penalties in certain cases.

(*a*) *Assessable penalties.*—Subsection (a) of section 5 of the bill amends subchapter B of chapter 68 of the code (relating to assessable penalties) by adding at the end thereof two new sections—section 6680, providing a civil penalty for failure to file an interest equalization tax return in certain situations where no tax is due, and section 6681, imposing civil penalties for executing false equalization tax certificates and for acting in disregard of the rules of national securities exchanges and national securities associations.

SECTION 6680. FAILURE TO FILE INTEREST EQUALIZATION TAX RETURNS

Section 6011(d) of the code, as added by section 3 of the bill, requires a person to file an interest equalization tax return even though

he incurred no liability for the tax if he would have incurred such liability but for the prior American ownership exemption of section 4918 of the code (except in connection with an acquisition with respect to which a written confirmation, furnished in accordance with the requirements described in sec. 4918 (c) or (d), is treated as conclusive proof of prior American ownership). Except for the criminal penalty provided in section 7203, these persons would incur no liability if they failed to file a return. The new section 6680 imposes on such persons a civil penalty of 5 percent of the amount of tax they would have been required to pay but for the provisions of section 4918. However, the penalty cannot be less than $10 nor more than $1,000. The penalty does not apply if it is shown that the failure to file is due to reasonable cause.

SECTION 6681. FALSE EQUALIZATION TAX CERTIFICATES

(a) *False certificate of American ownership.*—Section 4918(a) of the code exempts from the interest equalization tax those acquisitions which are made from another American person. Section 4918(b) provides that a certificate that the prior owner was an American person during the applicable period of his ownership is conclusive proof of American ownership for this purpose unless the person making the acquisition has actual knowledge that the certificate is false in any material respect. Under section 4918 (c) and (d) a blanket certificate of American ownership may be treated as conclusive proof of prior American ownership by members and member firms of national securities exchanges and national securities associations in specified circumstances, unless the member or member firm has actual knowledge that the certificate is false in any material respect. The effect of section 4918 is to relieve the person acquiring stock or a debt obligation covered by an individual or blanket certificate, even though the certificate is false, from payment of the tax unless he has actual knowledge of the falseness of the certificate.

Subsection (a) of the new section 6681 imposes on a person willfully executing a certificate of American ownership or a blanket certificate of American ownership which is false in any material respect a penalty equal to 125 percent of the tax (imposed by sec. 4911 of the code on the acquisition of the stock or debt obligation involved) which, but for the provisions of section 4918, would be payable by the person making the acquisition. The penalty is an assessable one and, when imposed, will enable the Government to collect the tax which was lost by reason of the execution of the false certificate, plus an extra amount to discourage persons from executing false certificates.

(b) *Liability of members of national securities exchanges and associations.*—Section 4918 (c) and (d) of the code set forth procedures under which receipt of a written confirmation from a member or member firm of a national securities exchange or national securities association will be treated as conclusive proof of prior American ownership in connection with an acquisition made on such exchange or in the over-the-counter market.

Subsection (b) of the new section 6681 provides a penalty for such members equal to 125 percent of the tax (imposed by sec. 4911 of the code on the acquisition of the stock or debt obligation involved in a transaction subject to the rules of such exchange or association as described in sec. 4918 (c) or (d)) which, but for the provisions of sec-

tion 4918, would be payable by the person acquiring the stock or debt obligation, if such member (A) willfully effects the sale of such stock or debt obligation or furnishes a written confirmation with respect to the purchase or sale of such stock or debt obligation other than in accordance with the requirements described in section 4918 (c) or (d); or (B) has actual knowledge that the individual or blanket certificate of American ownership in his possession is false in any material respect, or that the person who executed and filed the blanket certificate of American ownership in his possession was not a U.S. person at the time of the sale. The penalty is an assessable one and, when imposed, will enable the Government to collect the tax which was lost by the willful failure of the member or member firm to comply with the requirements described in section 4918 (c) or (d), plus an extra amount to discourage members and member firms from such willful failures to comply.

(*c*) *False certificates of sales to foreign persons.*—Subsection (c) of section 6681 imposes, on a person willfully executing a false certificate of sales to a foreign person described in section 4919(b) of the code, a similar penalty of 125 percent of the tax which is imposed by section 4911 on the acquisition of the stock or debt obligation involved and which, but for the application of the conclusive presumption provided in section 4919(b) and the reliance on the correctness of the certificate by the underwriter receiving the certificate, would be payable by the underwriter.

(*d*) *Penalty to be in lieu of tax in certain cases.*—Subsection (d) of section 6681 provides that unless the person acquiring the stock or debt obligation had actual knowledge that the certificate involved was false in any material respect, the penalty under subsection (a) or (c) of section 6681 will be in lieu of any tax on the acquisition of such stock or debt obligation under section 4911.

SECTION 5. PENALTIES—Continued

(*b*) *Criminal penalty.*—Subsection (b) of section 5 of the bill amends part II of subchapter A of chapter 75 of the code (relating to penalties applicable to certain taxes) by adding at the end thereof a new section 7241, providing criminal penalties for the willful execution of individual or blanket certificates of American ownership, or certificates of sales to foreign persons, which are false in any material respect. The criminal penalty is in addition to the assessable civil penalty provided in section 6681, discussed above. Section 7241 makes the offense of willfully executing a false certificate a misdemeanor and provides for a fine of not more than $1,000 or imprisonment for not more than 1 year, or both.

(*c*) *Clerical amendments.*—Subsection (c) of section 5 of the bill amends the table of sections for subchapter B of chapter 68 of the code, and the table of sections for part II of subchapter A of chapter 75 of the code, to reflect the new sections added to the code by subsections (a) and (b) of section 5 of the bill.

V. SEPARATE VIEWS OF REPUBLICANS ON H.R. 8000

GENERAL STATEMENT

H.R. 8000 is intended to restrict the flow of U.S. private investment capital abroad as a means of alleviating the balance of payments problem. As such, it is misdirected. The deficit in our balance of payments, which has persisted for the past several years, is not attributable to private investment abroad. In fact, in the private sector the amounts repatriated, either as a return on prior investment or as a repayment of prior loans, exceed the amounts reinvested.

The United States necessarily depends to a large degree upon private investment abroad, with the offsetting flow of funds to the United States as a return on that investment, or as a payment of prior advances, to provide a favorable balance in its foreign exchange accounts. In recognition of this, there was widespread opposition to the concept embodied in the bill on the part of the banking and business community. Even the Secretary of the Treasury was forced to admit that the long-term effect of this legislation will be adverse to our balance of payments. In fact, this was cited as the reason for making the legislation "temporary."

While H.R. 8000 is proposed as a "temporary" measure, there is no assurance that the administration will undertake to deal with the underlying causes which have brought about the deficit in the U.S. balance of payments. In fact, there is little likelihood that these basic causes will be remedied prior to December 31, 1965, which is the stated expiration date of H.R. 8000. For that reason it is wholly unrealistic to consider the bill as "temporary." If enacted, H.R. 8000 will become a permanent tax or penalty on certain types of U.S. private investment abroad, the threat of which will be used as a means of exercising control over all such investment.

We are not unmindful of the strain placed upon our balance of payments by foreign borrowers seeking advantageous U.S. long-term interest rates. However, the bill is not specifically directed at that type of transaction. The bill adopts a "shotgun" approach, with "built in" loopholes for "favored" U.S. lenders or foreign borrowers. In the final analysis, the Treasury is relying primarily upon so-called voluntary restraints rather than upon the legislation itself. While disclaiming any intention to invoke direct exchange controls, the results sought to be achieved by this bill depend more upon a "control" over the transactions which are exempt, than upon a tax on the transactions which are nonexempt. The Congress is in fact being called upon to enact this bill as a "club" for the Treasury to hold over certain segments of the financial community, both at home and abroad, in order to obtain from those who are exempt from the tax voluntary compliance with a program of control over capital outflow which will be left to the sole discretion of the President and the Treasury Department.

Since the bill is relied upon largely for its "psychological" effect—for the induced controls over investment abroad—there has been no

effort made on the part of the administration to press for the speedy enactment of this legislation. On the contrary, because of the threat of retroactivity in the bill, the Treasury has had almost absolute control over all U.S. investments and loans abroad since July 18, 1963. In the interim, there has been a sharp reduction in the outflow of U.S. capital. This should not be relied upon as an indication of what will happen when the bill becomes law. The uncertainty which exists today is a greater deterrent than the tax itself. Since the legislation was proposed on July 18, 1963, the only major transactions being consummated are those for which there have been reliable assurances of exemption. Once the bill becomes law, there may well be a substantial demand for U.S. capital abroad on the part of borrowers who will be willing, if necessary, to absorb the interest equalization tax.

DISCUSSION

H.R. 8000 is more significant for the transactions it exempts than for the transactions it purports to tax

The Ways and Means Committee was advised by the Secretary of the Treasury that the immediate need for this legislation was the strain placed upon our balance of payments by foreign borrowers seeking to take advantage of the low long-term interest rates in the United States. For that reason, the proposed bill was entitled an "interest equalization tax" bill. Yet we find that the bill exempts much of the long-term borrowing which supposedly created the problem and, at the same time, in the guise of an "interest equalization tax," taxes investment in foreign equity securities where there is no interest factor and no balance-of-payments problem.

In the course of the consideration of this bill, the Treasury Department submitted a schedule showing the outflow of private U.S. capital for the years 1960 to 1962, inclusive, and for three calendar quarters of the year 1963.

TABLE 1.—*Outflow of private U.S. capital to abroad after deducting inflow of private U.S. capital from abroad, 1960 to 3d quarter 1963*

[In millions of dollars; negative figures indicate excess of outflow over inflow]

	1960	1961	1962	1963 [1]			Total [2]
				I	II [3]	III [3]	
Direct foreign investments, net	−1,694	−1,598	−1,557	−501	−452	−161	−5,963
Short-term capital, net	−1,348	−1,541	−507	61	−508	123	−3,720
Long-term foreign loans by institutions	−200	−258	−248	−11	−131	−115	−963
New foreign bonds, after deducting redemptions	−459	−364	−832	−450	−461	−134	−2,700
Outstanding foreign bonds, U.S. purchases less sales	−102	−27	−29	−49	−47	34	−220
New foreign stocks	−14	−36	−74	−25	−7	−21	−177
Outstanding foreign stocks, U.S. purchases less sales	−75	−326	−26	1	−5	17	−414
Total	−3,892	−4,150	−3,273	−974	−1,611	−257	−14,157
Of which long-term portfolio capital (all above items except direct foreign investments and short-term capital)	−850	−1,011	−1,209	−534	−651	−219	−4,474

[1] Not seasonally adjusted; 2d quarter unrevised.
[2] 45 months.
[3] Preliminary.

Source: Treasury Department, Dec. 4, 1963.

It will be noted from the above table that there were substantial increases in the first and second quarters of the year 1963 in long-term foreign loans and new foreign bonds purchased in the United States. Other types of foreign investments do not reflect any appreciable increase. Nevertheless, H.R. 8000 purports to exempt a substantial portion of both long-term foreign loans and foreign bonds sales.

First, pursuant to the terms of H.R. 8000, direct foreign investments, amounting to a net outflow of $1.557 billion for the year 1962, will be exempt. In addition, special exemptions have been provided for investments which did not qualify under the exemption for "direct" foreign investments. Unquestionably, an undetermined an ount of the long-term foreign loans will fall within these special exemptions.

Secondly, H.R. 8000 exempts all loans for a term of less than 3 years. This provision will serve to exempt short-term capital outflow, which amounted to a net of $507 million in the year 1962, together with an undetermined amount which might have been borrowed for a longer term, but will be placed on a shorter term exempt basis.

Thirdly, H.R. 8000 exempts all bank loans irrespective of term. It is understood that approximately one-half of the long-term foreign loans by institutions, amounting to $248 million for the year 1962, will fall within this exemption. In addition, a substantial amount of the loans, which might otherwise be represented by foreign bonds, may be placed with the banks free of tax. In fact, since the announcements of the proposed tax on July 18, 1963, it is reported that the city of Vienna changed its plan for financing in the United States, from a proposed bond issue to a direct loan from the banks.

Finally, irrespective of category, an exemption has been granted to Canada. Approximately one-half of the foreign securities purchased by U.S. residents come from Canada.

TABLE 2.—*New issues of foreign securities purchased by U.S. residents, 1961 to 3d quarter 1963*[1]

[In millions of dollars]

	Total 1961	1962					1963		
		I	II	III	IV	Total	I	II[2]	III[3]
Canada	287	10	112	41	204	457	368	264	79
Western Europe	57	35	138	15	7	195	65	154	14
Japan	61	11	17	48	25	101	42	65	52
Latin American Republics	18	(4)	19	(4)	[5] 83	[5] 102	12	------	23
Other developed countries	43	(6)	(6)	(6)	(6)	60	------	17	------
Other less developed countries	95	(4)	(6)	(4)	(4)	77	19	17	11
International institutions and unallocated	12	80	1	3	------	84	------	------	------
Total, new issues	523	170	312	183	461	1,076	506	518	179

[1] Not seasonally adjusted.
[2] Revised.
[3] Preliminary.
[4] Less than $500,000.
[5] Includes $75 million issue by Inter-American Development Bank.
[6] Not available.

Source: Survey of Current Business and Department of Commerce, as supplied by Treasury Department, Dec. 3, 1963.

Accordingly, on its face, H.R. 8000 will accomplish very little. The exemptions provided for in the bill serve to exclude from tax the major areas of capital outflow, taxing only relatively insignificant transactions, such as the purchase of foreign stocks and the purchase of new foreign bonds (other than Canadian) where the borrower is precluded from obtaining the funds from a bank. Since most lending abroad, and for the most part foreign bonds, are purchased by institutional investors such as banks, insurance companies, and the like, the net effect is to permit the bank to lend money abroad tax free, but to deny to the other institutional investors the same right. The foreign borrower is "funneled" into the bank loan route.

In accounting for the seeming lack of scope of the bill, the Secretary of the Treasury was forced to disclose the real effect of the bill—not as a tax—but as a regulatory measure. Recognizing that the bill exempts much more than it taxes, the Secretary nevertheless stated that the Treasury does not anticipate any problem with respect to the exempt transactions. Why? Because, according to the Secretary, Canada will cooperate to limit the amount of the exemption which is to be granted for Canadian borrowings. And, what is more significant, the U.S. banks will "cooperate" so as to limit the amount loaned abroad by these banks. Thus, while the bank loan exemption admittedly constitutes a possible "loophole," the threat of taking away the exemption will be counted on to prevent the U.S. banks and the foreign borrowers from taking advantage of that loophole without the consent of the Treasury.

H.R. 8000 deals with a symptom, not the underlying causes of a balance-of-payments problem

Unquestionably, there has been an accelerated outflow of U.S. private capital in the form of long-term foreign loans and the purchase of foreign bonds. However, the bill is not specifically directed at these transactions, and actually exempts a substantial portion of foreign borrowing. The real purpose of the bill is to exert pressure against all forms of U.S. investment abroad. This ignores the underlying causes of the balance-of-payments problem.

There has been a growing lack of confidence in the ability of the United States to continue military and other foreign aid at existing levels. The United States has undertaken to guarantee, practically singlehandedly, not only the security of Western Europe but containment of the expansion of 700 million Communist Chinese. In addition to this tremendous burden, we may ultimately be faced with even greater financial burdens in Latin America. Our expenditures abroad for both military and nonmilitary aid have been running at the rate of about $4 billion annually. Unless and until we find a means of reducing this outflow of $4 billion annually, we will never solve the balance-of-payments problem.

TABLE 3.—*U.S. balance of payments, 1960— to 2d quarter 1963*

[In millions of dollars]

	1960	1961	1962	1963 [1]	
				1st quarter	2d quarter
Commercial trade balance	2,817	3,179	1,989	420	502
Commercial services balance	1,458	2,130	2,322	614	486
Balance on commercial goods and services [2]	4,275	5,309	4,311	1,034	988
Military expenditures	−3,048	−2,934	−3,028	−748	−717
Military cash receipts [3]	336	393	673	184	199
Government grants and capital-dollar payments to foreign countries and international institutions	−1,107	−1,116	−1,070	−235	−261
Government capital receipts excluding debt prepayments, borrowings, and fundings [4]	538	533	513	104	121
Remittances and pensions	−672	−705	−736	−212	−207
Private capital:					
Long term	−2,114	−2,143	−2,495	−1,022	−895
Short term	−1,438	−1,475	−716	58	−577
Unrecorded transactions	−683	−905	−1,025	−122	68
Balance on regular transactions	−3,913	−3,043	−3,573	−959	−1,281
Special Government transactions [5]	32	673	1,387	458	171
Overall deficit	−3,881	−2,370	−2,186	−501	−1,110

[1] Seasonally adjusted.
[2] Nonmilitary merchandise and service transactions less those financed by Government grants and capital.
[3] Excluding advances on military exports.
[4] Includes small changes in miscellaneous Government nonliquid liabilities.
[5] Not seasonally adjusted. Includes nonscheduled receipts on Government loans, advances on military exports, and sales of nonmarketable medium-term securities, including $350 million of nonmarketable medium-term convertible securities in the 1st quarter of 1963, and $152 million in the 2d quarter of 1963.

Source: Survey of Current Business, as supplied by Treasury Department, Dec. 3, 1963.

For the past 2 years, the administration attempted to conceal the seriousness of the problem through a series of "gimmicks." For the first time, in the consideration of this bill, the administration has set out separately these so-called special Government transactions in table 3 above.

These so-called special Government transactions were a temporary expedient—just as is H.R. 8000 designed to "buy time," and thereby to avoid facing the problem. First, the Western European nations were called upon to anticipate the payment of their debt obligations to the United States and to pay an advance for military supplies purchased from the United States. While these transactions resulted in a decrease in the net balance of payments, the underlying causes of the deficit were ignored. Secondly, when the possibility for advance payments from the Western European nations was exhausted, another expedient was resorted to to bring about an "improvement" on paper in our balance of payments. The Treasury borrowed funds abroad which, at the option of the lenders, were repayable at a fixed rate of exchange in the foreign currency. It is reported that approximately $500 million of these obligations were issued during the 6 months ending June 30, 1963. This form of financing solved nothing.

There is unquestionably a "tight" world money market. Any action taken to restrict funds in the United States from going into that market in particular types of transactions will necessarily be reflected in offsetting pressures elsewhere. For example, the sale abroad of U.S. Government obligations (either repayable in foreign funds or convertible into such funds) was resorted to as a means of offsetting

the demand against U.S. gold stocks. The withdrawal of such capital by the United States was immediately offset by an increase in long-term borrowing by foreign borrowers in the U.S. capital market. From the standpoint of our balance of payments, the net result was the same as if the Treasury had not resorted to these bonds as a substitute for meeting the demands on the U.S. gold.

Faced with this dilemma, the Treasury proposes to establish independent capital markets outside of the United States. The committee was told that the U.S. capital market—headquartered in New York City—could no longer meet the world needs for capital. Therefore, it was hoped that the effect of this legislation might lead to the establishment of competing capital markets elsewhere. We challenge the desirability of that result, even if it could be achieved—which we doubt. It is isolationism on the part of a nation which has undertaken as a major objective the promotion of free trade. The result will be detrimental to the position of the United States as leader of the free world in the economic struggle against the Communist bloc. Instead of compromising our position of financial leadership of the free world by curtailing private outflow of capital, we should reappraise our governmental expenditures abroad. Governmental expenditures should be reduced before private investment.

H.R. 8000 will adversely affect balance of payments by restricting U.S. investment abroad

In proposing to control or tax U.S. investment abroad as a means of improving the balance-of-payments deficit, the administration has elected to sacrifice the long-range benefits which flow from such investment in order to gain a dubious short-range advantage. In fact, any advantage is predicated upon the doubtful assumptions (1) that there will not be an offsetting decrease in foreign investment in the United States and foreign purchases of U.S. products, and (2) that the curtailment of U.S. investment abroad will be "temporary." The administration claims that the Trade Expansion Act of 1962 and the pending tax reduction bill ultimately will bring about a sufficient increase in exports to offset the existing deficit in our balance of payments. These assumptions completely overlook the changes which are taking place in the world about us.

All of the nations are today striving toward industrialization. Canada proposes to put severe restrictions on the imports of automotive parts from the United States to be used in the assembly of automobiles in Canada. Similar restrictions have been imposed by other nations where U.S. automotive manufacturers have assembly plants. India seeks U.S. aid in order to expand its capacity for steelmaking. The U.S. commercial trade balance cannot achieve any long-range growth in the face of such pressures. In fact, as compared with the 1960–61 average, this balance shows a decline of more than $1 billion in the calendar year 1962 and promises a similar decline in the calendar year 1963. The only real "bright spot" in our balance of payments is reflected in the growth of private investment income. Private investment income has increased from approximately $2.9 billion for the year 1960 to an estimated $4 billion for the calendar year 1963. A breakdown of the items making up the commercial

surplus in our balance of payments is set forth in the table which follows:

TABLE 4.—*U.S. balance of payments—Commercial surplus on goods and services, 1960 to June 1963*

[In millions of dollars]

	1960	1961	1962	Change, 1960–62 (improvement +)	January to June 1963, seasonally adjusted
1. Nonmilitary merchandise exports	+19,459	+19,913	+20,479	+1,020	+10,454
2. Less exports financed by Government grants and capital	+1,919	+2,237	+2,345	+426	+1,427
3. Commercial merchandise exports (1-2)	+17,540	+17,676	+18,134	+594	+9,027
4. Nonmilitary merchandise imports	−14,723	−14,497	−16,145	−1,422	−8,105
5. Commercial trade balance	+2,817	+3,179	+1,989	−828	+922
6. Private investment income	+2,873	+3,464	+3,850	+977	+2,005
7. Other nonmilitary service receipts	+4,307	+4,532	+4,801	+494	+2,490
8. Less services financed by Government grants and capital	+288	+430	+538	+250	+339
9. Commercial service exports (6+7−8)	+6,892	+7,566	+8,133	+1,221	+4,156
10. Nonmilitary service imports	−5,434	−5,436	−5,791	−357	−3,056
11. Commercial services balance	+1,458	+2,130	+2,322	+862	+1,100
12. Commercial surplus	+4,275	+5,309	+4,311	+36	+2,022

Source: Treasury Department, Dec. 3, 1963.

Commercial goods and services sold abroad already produce a favorable trade balance. Unquestionably, some exports can be increased. Such increases will, however, be slow and hard won. The industrial capacity of our major world customers to supply themselves has been expanded, largely with U.S. aid. Our former customers all strive towards self-sufficiency. Every nation, no matter how small or how weak economically, seeks to establish productive facilities in order to avoid having to import steel, chemicals, oil, and even manufactured goods such as automobiles and parts, and household appliances. This trend will make difficult any dramatic expansion of U.S. exports.

The tax rate reductions in the proposed Revenue Act of 1963, now pending before the Senate Finance Committee, are relied upon to bring about a substantial increase in consumer purchasing power in the United States. Such an increase will inevitably result in a corresponding increase in merchandise imports (table 4, item 4). Tax reduction will produce no offsetting increase in merchandise exports (table 4, item 3). As a net result, the U.S. commercial trade balance may be reduced. To counteract this effect it is necessary to encourage investment abroad, with the accompanying increased return on such investment. This bill is a backward step toward the solution of the problem. Instead, we should be striving to increase U.S. ownership of foreign income-producing assets.

CONCLUSION

For the reasons stated, the undersigned Republican members of the Ways and Means Committee are opposed to the enactment of this legislation.

H.R. 8000 is another effort to "cover up" the underlying causes which have brought about recurring deficits in our balance of payments. Even its proponents concede that the legislation is undesirable as a long-term measure. On the other hand, we have seen no program advanced by the administration which would serve permanently to meet the problem. In fact, the recent reduction by the Congress in foreign aid appropriations was bitterly opposed by the administration spokesmen.

No one should be deceived by this bill. The administration disclaims any desire to control foreign exchange. Except for its induced effect as a "control" on all U.S. investment abroad, the bill would accomplish little. We would be opposed to direct control over U.S. investment abroad, and are equally opposed to the attempt by this bill to achieve that result indirectly.

If the United States is to maintain its position as leader of the free world in the cold war with the Communist bloc, and particularly in the economic confrontation, we must maintain our position as the financial leader of the free world. That position can be maintained only so long as we provide a free capital market. Our position of leadership imposes upon us that burden. Indeed, to be banker to the world is a profitable occupation. This bill would seek to destroy that position. It reflects a "defeatist" attitude which we cannot accept.

John W. Byrnes.
Thomas B. Curtis.
Victor A. Knox.
James B. Utt.
Jackson E. Betts.
Bruce Alger.
Steven B. Derounian.

O

20 August 1964

MEMORANDUM FOR: Assistant to the Director [redacted] STAT

SUBJECT: H. R. 8000 - Interest Equalization Tax Act

1. On 19 August the Senate accepted the conference report on H. R. 8000, the Interest Equalization Tax Act. This Act will now be sent to the President for his signature.

2. As soon as a copy of the Public Law is available, we shall forward it to you.

[redacted] STAT

Office of Legislative Counsel

Distribution:
Orig & 1 - Addressee
1 - OGC/LC Subject
1 - OGC/LC Chrono
1 - OGC/LC Signer

OGC/LC/PJC:bw

STAT

Approved For Release 2005/05/18 : CIA-RDP66B00403R000500200001-2

2 March 1964

STAT

MEMORANDUM FOR: [redacted]

SUBJECT: H. R. 8000

H. R. 8000 will be up for floor action on Tuesday under rule providing for three hours of debate.

JOHN S. WARNER
Legislative Counsel

Approved For Release 2005/05/18 : CIA-RDP66B00403R000500200001-2

13 November 1963

MEMORANDUM FOR: Director of Central Intelligence

SUBJECT: H. R. 8000 - Interest Equalization Tax Act

1. This memorandum is for information only.

2. Attached is a rather detailed analysis of H. R. 8000 prepared in this office. Also attached are the printed hearings on this bill. This is an Administration measure to stem the outflow of long-term capital from the U. S.

3. At the present time all hearings have been completed and it was planned that there be executive sessions this week looking toward a markup of the bill and reporting it out. It seems very likely the bill will probably pass the House after having been reported favorably but it is doubted that we will see any action on the Senate side this year. It should be noted that the effect desired by the legislation has in part already been achieved in that the additional tax will apply on acquisitions made after 18 July 1963 thus slowing the investment flow.

4. Also attached is an excerpt from The Washington Post commenting on this bill. From our sources in Treasury and on the Hill, we agree generally with the conclusions of this article.

s/ John S. Warner

JOHN S. WARNER
Legislative Counsel

Atts. - 3
Distribution:
Orig - DCI w/atts
1 - ER w/o atts.
1 - Leg. C. Subject w/o atts.
1 - Leg. C. Chrono. w/o atts.

OGC/LC:JSW:mks